Strong and Efficient Investor Protection

Dealers and Advisers under the BC Model — A Regulatory Impact Analysis

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BCSC

A NEW WAY TO REGULATE

BRITISH COLUMBIA SECURITIES COMMISSION

About This Study

This study is the second in a series of economic and regulatory impact studies being prepared by the British Columbia Securities Commission to analyze the impact of the most significant changes embodied in the BC Model – draft legislation and rules designed to implement a modernized system of securities regulation for British Columbia. The BC Model includes a proposed Code of Conduct and other outcomes-based rules for the regulation of dealers and advisers. This study analyzes the impact of these new rules on investor protection and the regulated community.

The first study in the series, *Better Disclosure, Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System*, is on the BCSC website at www.bcsc.bc.ca/bcproposals. Future studies will analyze the impact of the BC Model's Firm-Only Registration and Investor Remedies proposals.

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Executive Summary

On April 15, 2003, the British Columbia Securities Commission published the BC Model – draft legislation and rules designed to implement a modernized system of securities regulation for British Columbia. The BC Model includes a proposed Code of Conduct and other outcomes-based rules for the regulation of dealers and advisers.

The BC Model represents a significant shift in how dealers and advisers would be regulated. It moves regulation in this area farther toward the principles-based end of the regulatory spectrum. In our consultations with hundreds of people in the dealer and adviser businesses, we have learned that many support the new approach, but some concerns have been expressed. These concerns fall into three major areas:

1. Would the BC Model protect investors as well as the current system?
2. Would dealers and advisers know what to do, and behave as expected, under the BC Model?
3. Would the BC Model impose significant transition or new ongoing costs to dealers and advisers?

This paper contains the results of a regulatory impact analysis that we conducted to find answers to these questions.

The study is based on extensive interviews and analysis we conducted with four registered firms with distinct operational characteristics. We compared their operations under the current rules with how they expected they would change those operations under the BC Model. We also conducted simulations of how compliance reviews and enforcement would be conducted under the BC Model compared to the current regime.

These are our conclusions.

1. The BC Model would improve investor protection.

The BC Model's emphasis on outcomes would help keep the compliance focus aligned with the interests of investors and markets. The firms in our study said they would use the Model's procedural flexibility to re-allocate resources to more effective means of preventing and detecting misconduct. The outcomes mandated by the BC Model are broad enough that most new compliance and enforcement challenges can be dealt with faster than under the current legislation. The simulations conducted by Commission staff show that the BC Model provides a stronger foundation for effective compliance reviews and enforcement action.

2. The BC Model would have the intended result.

The firms we interviewed concluded that they would know how to apply the Code of Conduct and the other outcomes-based rules contained in the BC Model. The BC Model allows firms to achieve all elements of investor protection in the way that is most efficient for their business.

3. *The BC Model would not impose a cost burden on industry.*

Our analysis of the data provided by the participating firms indicates that implementing the BC Model would not increase ongoing compliance costs, nor would it entail significant transition costs. The BC Model's simpler rules and less frequent rule changes would reduce ongoing compliance costs. When firms are free to decide for themselves how to achieve desired regulatory outcomes, they can design policies that make best use of their structural advantages. We can expect them to do so more efficiently than a regulator that uses traditional rules and builds one solution for all players.

I. Methodology

The BC Model represents a significant shift in how dealers and advisers would be regulated. It moves regulation in this area farther toward the principles-based end of the regulatory spectrum. This shift would affect firms several ways. Some procedures firms would stop doing. Others they would streamline. Others would be left as is. And in some areas, firms would have to do new things. All of these changes would be reflected in the myriad details of day-to-day compliance management. Therefore, the impact of implementing the BC Model cannot be measured without fully understanding these detailed changes.

Study based on detailed reviews of four firms

One typical method of determining the impact of regulatory changes is to survey the current cost of compliance, explain the proposed changes to survey participants, and then ask them to estimate the new costs as a result of the changes. The result can then be sized up across the whole industry. That is essentially what we did in our cost-benefit analysis of the Continuous Market Access System last year (see *Better Disclosure, Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System* on our website).

But a broad-based survey would not have worked well in this case. The regulation of dealers and advisers proposed under the BC Model represents a new way of thinking and oversight. There is too much to learn about the BC Model to be accurately articulated in a survey, and each firm's interpretation of the changes would depend on its operational characteristics. Neither would a survey capture the logic behind the firms' responses to questions about how they would comply with the BC Model, which is an important means of addressing qualitative issues relating to changes in investor protection and registrant behaviour.

Instead, we chose to analyze the impact of the BC Model on four IDA member firms with distinct operational characteristics. The four included a national bank-owned dealer based in Toronto, and three BC-based dealers: a large national independent dealer, a medium-sized regional dealer, and a small regional dealer.

These four firms took the time to understand the BC Model and work through its implications for their businesses. At each firm, we met with compliance staff, informed them about the BC Model and what it replaced. We concentrated on the areas of compliance they identified as most significant and asked them how a Code would change their compliance obligations and approach. Through these interviews and an extensive review of their compliance documentation, we learned:

- what parts of their compliance procedures would fall under the Code of Conduct
- what parts of their procedures reflected BCSC requirements, what parts SRO requirements, and what parts their own choice of good business practice
- how they would change those requirements in the short term under the BC Model
- how those requirements could ultimately change under the BC Model, and
- the cost implications of those changes

Studying every aspect of regulation would have been too unwieldy and time-consuming. To keep the scope of the study within manageable limits, we limited it to three areas of compliance:[1]

- Account supervision – This is currently regulated and would still be regulated under the BC Model. Firms believe they would change their practices significantly in this area under the BC Model.
- Marketing – This is currently regulated but would not be specifically regulated under the BC Model. Firms do not believe they would change their practices significantly in this area under the BC Model.
- Analyst conflicts – When our study began, this was not regulated but was the subject of proposed new rules, which have since been adopted.[2] It would also be specifically regulated under the BC Model, but in a very different way. These two approaches to this new area of regulation highlight the different regulatory focus of the BC Model.

We believe the results we obtained from focusing on these three areas are generally representative of the impact that the BC Model would have on investor protection and on the regulatory burden on dealers and advisers because they cover important elements of investor protection and include significant cost drivers for firms.

Compliance review and enforcement simulations

In a separate internal process, Commission staff tested the effectiveness of the BC Model for compliance reviews by applying it to the facts of previously completed examinations of dealers and advisers. The examinations chosen for review included typical problems and we believe the results of this analysis are generally representative of what the results would be under the BC Model.

We also tested the enforcement powers of the BC Model using a similar methodology applied to previously-issued Commission decisions and settlements.

Significance of SRO rules

Comparing the BC Model to the self-regulatory organization (SRO) regimes is a good way to test the potential impact of the BC Model. All firms registered in the dealer category are members of either the Investment Dealers Association of Canada (IDA) or the Mutual Fund Dealers Association of Canada (MFDA). The rules of these two SROs are much more detailed than the requirements under the legislation, both current and proposed, and IDA and MFDA member firms are affected more by IDA and MFDA rules than by the rules of the BCSC. This is partly because the current regulatory system intentionally delegates detailed regulation to the SRO level. The SRO regime also represents a more rules-based approach to regulation. In many cases, the requirements under securities legislation are not relevant, either because SRO members are exempt from those requirements if they follow SRO rules, or because SRO requirements exceed those under securities legislation. Therefore, when the firms we interviewed think about regulatory compliance, they think more about SRO rules than BCSC rules.

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[1] The other areas of IDA regulation that relate to matters covered by the Code of Conduct included account opening and transfers, client complaints, safekeeping, and fee and investment disclosure.

[2] The IDA adopted Policy 11 *Analyst Standards* on October 27, 2003. It becomes effective on February 1, 2004.

Because SRO rules are the dominant factor in the compliance burden on SRO member firms, implementing the BC Model without corresponding changes in SRO rules would have little impact on these firms. Any changes to SRO rules would obviously be subject to discussions with the IDA and the MFDA. Although this paper deals extensively with the impact of IDA rules on the four firms that participated in this review, we have not yet discussed with the SROs the results of our analysis or the changes to their rules that would be required to make the BC Model work effectively for their member firms.

II. The BC Model

Overview

The BC Model is in four volumes:

Draft Legislation
Commentary on Draft Legislation
For Dealers and Advisers – Your Guide to Securities Regulation in British Columbia
For Issuers – Your Guide to Securities Regulation in British Columbia.

The BC Model includes a proposed new scheme of regulation relating to the registration of dealers and advisers, and to their conduct, which is the focus of this study. Regulation specific to the ongoing conduct of dealers and advisers is found in 28 rules contained in a Code of Conduct and 15 rules outside the Code. These rules apply to all registered firms; most also apply to representatives of those firms. The Code (with accompanying guidance) and the 15 rules outside the Code are in Appendix 1.

These 43 rules replace 62 sections in the current legislation and 16 other instruments (see *Commentary on Draft Legislation*, Appendix A – Table of Concordance.)

In addition to rules specific to the conduct of registrants, the BC Model includes general conduct rules for all market participants in Part 10 of the *Draft Legislation*. These include prohibitions against:

- misrepresentations
- manipulation and fraud
- unfair practices
- insider trading or tipping
- front running
- false or misleading statements to the Commission
- obstruction of justice

Most of these exist in some form under the current legislation.

A dealer or adviser who contravenes any of the provisions of the legislation or rules, including the Code of Conduct, would be exposed to administrative sanctions, civil liability, and, in some cases, criminal prosecution.

The Code of Conduct

When building the Code, the BCSC started from a blank page. We developed a set of rules for the business conduct of dealers and advisers to achieve the critical outcomes necessary for investor protection and market integrity. We then identified these outcomes by analyzing the current legislation, as well as codes adopted by organizations here and in other jurisdictions. The resulting 28 rules in the Code are

arranged under eight broad principles, each addressing a key area of investor protection:

1. Integrity and fairness
2. Dealings with clients
3. Confidentiality
4. Proficiency
5. Know your client and suitability
6. Conflict of interest
7. Compliance systems
8. Client complaints

In some cases, the Code essentially keeps current requirements. For example, the rules in the Code dealing with basic integrity, know your client, and suitability mirror very closely the language of the current legislation.

In other cases, the rules in the Code are less prescriptive than those in the current legislation, but are intended to achieve superior outcomes. For example, the current legislation requires a firm to file information with the Commission about certain types of material changes to the information in its registration, including criminal charges or convictions and bankruptcies of its partners, directors or officers.[3] The current legislation does not specifically require this information to be disclosed to the client.[4] Under the Code, however, both the firm and the representative must inform clients of "all facts that a reasonable person would consider important to the business relationship."

Some provisions would be repealed and not replaced in the Code. For example, the current legislation prohibits cold calls to residences. This prohibition (which by exemption does not apply to IDA and MFDA members) is not included in the Code because abusive behaviour conducted over the phone is adequately addressed by the prohibitions in the BC Model against misrepresentation, fraud, and unfair practices.

Finally, the Code includes new provisions. For example, the Code would require that the dealer or adviser tell the client any information that a reasonable client would consider important in determining the dealer's or adviser's ability to provide objective service or advice. This covers a wide range of conflict of interest issues and requires full disclosure in plain language of anything related to compensation that the dealer or adviser receives in connection with its work for the client. This is more comprehensive disclosure than is required under the current legislation.

Other Rules of Conduct

In addition to the 28 rules in the Code, the BC Model has 15 other rules[5] regulating the ongoing conduct of dealers and advisers. These rules are much less prescriptive than the rules they replace, but are intended to achieve the same outcomes in areas such as record keeping, reporting requirements, and capital and bonding.

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[3] Act, s. 42.

[4] Except to the extent required by section 14 of the Rules, which requires a registrant to deal fairly, honestly and in good faith with its clients.

[5] BC Model, *Draft Legislation*, Rules Part 3, Divisions D and E.

Guidance

One of the BC Model publications, *For Dealers and Advisers – Your Guide to Securities Regulation in British Columbia*, is a sample of one form of guidance that would be available to dealers and advisers under the BC Model to help them interpret the requirements.

This guidance is not part of the rules and therefore does not have the force of law. It is intended to supplement the rules by helping registrants to interpret them. Although in many cases, it would be hard to comply with the Code without following the guidance, what would count under the BC Model is whether the firm delivered the outcomes contemplated by the BC Model, not how closely it followed the guidance.

III. Investor Protection

Regulating the conduct of registered firms and their representatives is one of the major investor protection elements of securities regulation.

We focused our analysis on three areas of dealer regulation – how they prevent and detect misconduct through account supervision and reviewing marketing materials, how they manage conflicts of interest, and how audits, compliance reviews, and enforcement actions are carried out. This chapter compares current practice in these three areas to what firms told us what they thought would happen under the BC Model.

In analyzing current practice we examined of the effect of current IDA rules and procedures and compared them with how the same areas would be regulated under the BC Model. This work is based on our work with and review of the four firms that participated in the study. This study is not a review of the IDA and the IDA has not yet had an opportunity to review the results of our analysis.

A. Preventing and Detecting Misconduct

1. Account Supervision

Securities legislation imposes a duty to supervise, but does not prescribe the methodology. Details are prescribed at the SRO level. The IDA and MFDA each have policies that require daily and monthly reviews of accounts for trading violations, suitability, and business risk factors. The SROs monitor compliance with these rules through sales compliance audits.

Many IDA firms must also comply with additional supervision requirements imposed by Market Regulation Services, Inc. (RS), the SRO that provides independent regulatory services to marketplaces, quotation and trade reporting systems and alternative trading systems, and the dealers that operate in those marketplaces. Dealers subject to RS jurisdiction must comply with the Universal Market Integrity Rules (UMIR). Many areas of supervision in UMIR overlap IDA rules.

Registrants who are not members of an SRO, such as portfolio managers, are subject only to the basic supervision requirement in the legislation.[6] Sales compliance reviews for these firms are conducted by Commission staff.

Findings

This summarizes what the four firms who participated in the study told us about their compliance management experience in the area of account supervision under the current rules.

[6] See *Securities Rules*, sections 44, 47.

1. IDA Policy 2 specifies the requirements for daily and monthly reviews. Daily and monthly reviews are transactional by nature and the firms told us they do not find these reviews useful for detecting abuses based on a pattern of behaviour. Yet, as the firms told us, the biggest risks usually arise from pattern-based behaviour. For example, concentration of securities is potentially a problem for the firm overall, for a specific adviser's clients, or for an individual, but the daily and monthly reviews are not effective at detecting aggregated concentration anomalies. Similarly, front running or stock manipulation are characterized by patterns of trading behaviour, again difficult to detect through the transactional focus mandated by daily and monthly reviews.

2. However, all firms agreed that some transactional reviews are necessary, although for different reasons. The smaller firms had fewer dissatisfactions with transactional reviews. They felt that daily and monthly reviews were useful as core compliance tools, assuming they had the flexibility to establish their own thresholds. Because these firms are small, manual processes can be effective for detecting patterns. Larger firms have too much to review to do the same, so they need expensive technological solutions to make transactional reviews effective. The largest firm saw transactional reviews on a sampling basis as a valuable defense to civil liability.

3. Policy 2 requires daily reviews to assess each trade against 19 criteria (and another eight if the trade is in futures or options).[7] The firms we interviewed also reviewed for some things not required by Policy 2.[8]

4. Policy 2 contains many thresholds that define which trades need to be reviewed. For example, every account with over $1,500 of commissions in a given month must be reviewed. The firms told us that these thresholds are too low and too rigid. For example, many mutual fund trades are not caught because they do not generate commission, yet highly active trading in mutual funds may well merit review. Conversely, the threshold catches thousands of self-directed trades, trades in blue chips and GICs, and sales transactions that generate more than $1,500 in commissions but do not carry the risks the Policy seeks to detect. One firm estimated that up to 85% of what it reviewed through the daily review process found nothing that warranted a closer look.

   Firms suggested alternatives to thresholds, such as:
   - reviewing all portfolios that hold more than 30% of the account value in stocks priced below five dollars
   - reviewing accounts for representatives who, in the past week, sold three or more clients the same stock, if the stock is priced below five dollars
   - raising the threshold and sampling below it
   - reviewing accounts by cumulative commissions or expenses and varying the threshold figures throughout the year

[7] See Appendix 2. Policy 2 under MFDA rules takes a more principles-based approach. For example, it does not dictate the sampling method and cites only 8 required daily screens.

[8] For example, debit rolling, re-aging, radical portfolio changes, unusual cheque activity, mutual fund switches, and unusual orders.

- considering factors such as a drop in account value over a certain percent that was not due to a withdrawal, a number of transactions that exceed a given number, or a turnover ration higher than a given percentage

5. Both large firms discussed with us how the daily reviews are so thorough that most things detected on monthly reviews were already investigated in the daily reviews. For example, all individual trades are checked for suitability in the daily review and against the restricted list at the time of the trade. There is therefore no need to recheck for these items in the monthly review, which would be more productive if it focused on areas more easily seen over the course of a month's trading, such as increasing concentration, churning, and changes in the portfolio balance. Firms could also choose to leave suitability reviews to the monthly process if they believe that to be the better context.

6. The firms identified some reviews that duplicate others. For example, suitability reviews are likely to uncover high-risk trading strategies and churning, yet there is a separate mandated review process for each of these. Similarly, the rules require post-trade reviews of trades in restricted and suspense accounts; this is unnecessary for the many firms that require those trades to be cleared before they occur. The rules also require review of trades in restricted securities; the firms we interviewed with investment banking functions have automated systems that disallow these trades, so for them, this review is not necessary.

7. Large firms subject to UMIR have another area of duplicated effort. Several areas that are related to trading violations are regulated under UMIR as well as under IDA Policy 2. One of the large dealers reviewed concentration, excessive trading, suspicious crosses, conflicts of interest, excessive transfers and cancellations, front running, quality downgrading, and internal trading restrictions violations under UMIR, all of which are also covered under Policy 2. The UMIR rules focus on pattern reviews and leave it to firms to determine how to monitor compliance. However, there is no relief from the overlapping requirements of Policy 2, which does not give firms the same flexibility.

8. The firms told us that following the rigid guidelines under Policy 2 mandated transactional reviews consumed resources that would be better spent identifying the patterns and trends of non-compliance. The firms believe that a supervision regime that used risk-based sampling to focus the selection of accounts for review would be significantly more efficient, with minimal loss to the detection of serious non-compliant behaviour. For example, one of the large firms, which spends 70% of its review time looking at trades and 30% looking at patterns, told us it believed the reverse would be the better ratio. It said that more time spent on pattern surveillance would allow them to dig deeper into the patterns of behaviour that are indicators of significant risk.[9]

9. The other large dealer said it detects 90% of potential compliance problems through its proprietary system that it runs first. Daily reviews catch the remaining 10%.[10]

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[9] An example of a pattern review they believe is effective is a book review of individual brokers that are selected by a risk-based system.

[10] The firm is able to detect these problems using a pattern-based methodology using only a few of the Policy 2 daily review criteria.

Each process takes the same amount of time, which suggests that this dealer could cut the time it spends on reviews in half (by dropping the mandated daily reviews) and still detect 90% of what it is catching today.

10. Even if a firm's procedure is more effective than the procedures mandated under Policy 2, it must still comply with the Policy 2 procedures.[11]

11. The firms identified 23 review criteria under Policy 2 (out of a total of 90) that they would not use under the Code. For most of the critieria they would keep, they would change the supervision method.

12. The firms often made the point that they need to do supervision properly as much for civil liability reasons as for regulatory ones. This creates a market-driven need to supervise for elements of account activity that are obviously material.

13. The focus on transaction reviews under the current rules is aggravated by the time the firm's compliance officers (and sales staff) must also spend documenting those reviews for the purposes of the IDA sales compliance audit. Some firms commented on the regulatory creep involved in the IDA audit process. Audits done years ago simply confirmed that the firm did the reviews. Then audit standards began to look behind the review process, requiring firms to follow a specific documentation process.[12]

14. Auditors can comment on procedures even if those procedures are not specifically required in the regulation. Signing and dating blotters is a case in point. Another example is auditing for procedures to detect day trading, though this is not a required review point in Policy 2 (except for options trading).

Analysis

Supervision under the Current Regime

The current regime seeks to provide investor protection by prescribing specific compliance procedures and auditing firms tightly to ensure they follow them. Implicit in this approach is the assumption that the mandated procedures will be effective in detecting compliance problems and therefore investors will be protected.

However, the findings show that this assumption is suspect. Although firms believe that the mandated review procedures have some value, all of the firms have modified and supplemented those procedures in order to ensure that they detect the most high-risk

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[11] Policy 2 allows firms to apply for exemptions from its requirements if the firm can show that it has "policies and procedures appropriate to supervise trading of its clients", but the firms we interviewed have not applied, even though, in the case of the large firms, the benefits would be significant. One firm said that the preparation necessary to build the case to use an alternative system would be significant – so much so that they do not have the senior compliance resources available to prepare the application. Another thought that the time and cost of being the first to apply for this relief would be too high.

[12] IDA audit standards require proof that the appropriate person did the reviews and dated them. Firms are cited if compliance officers fail to sign and date original copies, or fail to conduct a review within a prescribed time. Firms must document their inquiries into suspicious transactions, and the responses they receive from branch officers and sales representatives. One compliance officer told us that dating a blotter is a waste of time: "Who's to say when I really did it?" Others point out that signing and dating could just mean assuming the liability without actually doing the review. Another firm has an electronic documentation system that records and dates detailed evidence of reviews, yet the IDA audit standards require paper files as well.

non-compliant behaviour. Had they the freedom to do so, the firms would modify these reviews even further, by adjusting the thresholds for reviews, re-focusing the review list to material issues, or shifting emphasis in various areas between daily and monthly reviews.

Firms would also go further and re-allocate resources from transaction-based reviews to pattern-based reviews.

This reflects the problems inherent in the application of the same set of rigid standards to firms with varying operational characteristics. For example, the thresholds in Policy 2 that trigger daily and monthly reviews were probably originally designed to ensure that all higher-risk transactions were reviewed without requiring the review of every single trade. Yet on a daily basis a firm is currently obliged to review every trade at the branch level. Daily reviews at the head office include a list of 12 criteria, three of which are thresholds based on dollar trade volume. The monthly thresholds require the review of all pro trades, but do not require the review of account statements showing less than $1,500 in commissions. Interestingly, each firm we interviewed would still use thresholds, but each of them would modify them in different ways based on the compliance experience each has had in its own business.

What is clear is that firms no longer find these thresholds useful – they have not stood the test of time. This illustrates the difficulty of keeping detailed regulatory requirements relevant with the passage of time. The findings also show that the firms feel that even within the transaction-based environment, there are duplicative and unnecessary requirements.

The largest area of concern, however, was over what the mandated transaction-based reviews did not detect. This is the area where the firms had done the most independent work in developing compliance systems, because they believe that the highest-risk areas of non-compliance are related to pattern-based behaviour. These firms believe it is most important to identify the highest-risk areas of non-compliance, assess the patterns and trends associated with those areas, and then design the surveillance system to close those windows of opportunity for misconduct.[13] [14]

The larger firms have developed parallel surveillance systems designed to detect patterns and trends associated with high-risk behaviour, but they also expressed frustration that the time required to undertake and document the mandated processes prevents them from expanding these systems. They believe that were they able to do so, they could detect non-compliance better than they can today. The starkest illustration of this was the firm that could cut its compliance resources in half and still catch 90% of its high-risk activity. Interestingly, this firm said that if it were given more flexibility, it would not cut these resources, but would re-deploy them to more effective methods. This was echoed by the other large firm.

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[13] One firm cited reviews of sell orders as an example of the ineffectiveness of transaction-based reviews. "When is a sale ever not suitable," it asked. A sale could be an indicator of churning or portfolio downgrading, but this would not be evident until the ensuing purchase. Even then, a sales representative could easily avoid detection under a transaction-based review system by spreading the transactions over a few days, or straddling a month-end.

[14] The MFDA's interpretation of its Policy 2 diminishes this problem by mandating a sampling methodology for all but the riskiest trades. Similarly, UMIR focuses on a pattern-based approach (price manipulation, front running, etc.) and leaves it to firms to determine how to monitor for this. In both of these cases, the policies are built to be more efficient because firms choose the process that they feel meets the supervision criteria.

The smaller firms have individuals, not departments, dealing with compliance. They also have used their small scale and tighter pyramid structures to cover off on account supervision in ways that de-emphasize daily and monthly reviews.

Policy 2 treats all representatives equally, yet not every representative presents the same risk profile to the firm and its clients.[15] As one of the firms pointed out, reviewing all trades of all representatives to the same extent and using the same criteria leaves little time to review more rigorously the books of problematic representatives. Had it the time, the firm could increase its use of a proprietary process to look at trading patterns of higher-risk representatives, and be more successful at early detection of problems in the areas of suitability, concentration, excessive trading, downgrading, inappropriate crosses, and so on.[16]

The firms were unanimously of the view that the mandated transaction-based systems contributed significantly to their regulatory burden without providing meaningful investor protection. This burden is aggravated by the documentation and other compliance requirements associated with the audit process.

Supervision under the BC Model

The obligation to supervise arises primarily from the rules in Principles 1 and 7 of the Code of Conduct. Under these Principles, a firm must:

- act fairly, honestly and in good faith and in the best interests of the client
- exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances
- comply with all relevant laws and regulations
- not engage in conduct that would bring the reputation of the securities market into disrepute
- maintain an effective system to ensure compliance with the Code, other legal requirements, and its own internal policies and procedures
- maintain an effective system to manage the risks associated with its business

The rules in the Code are accompanied by guidance that interprets the rules, sometimes using illustrations of misconduct and inappropriate behavior.

In addition, firms and their directors have a defence to civil liability under the BC Model if they have adequate compliance systems in place and a system to monitor compliance with those systems, and they follow them.

Firms are therefore both required and motivated to supervise account activity and formalize their compliance processes.

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[15] The MFDA supervisory rule, which is newer, recognizes this problem and mandates closer supervision of activity for certain representatives. Because firms have more discretion in choosing what to review, this guidance is helpful to illustrate acceptable trade offs in managing risk.

[16] Under this firm's system, the representatives reviewed are chosen based on history of client complaints, issues identified in other reviews, or show unjustified revenue based on history. It looks at the risk tolerance of each client managed by that representative, along with their investment objectives, margin, performance, and commissions. In aggregate, it looks at the top ten holdings of the representative's clients, the complaints the representative has received, outstanding documentation by the representative, and other such issues.

The Code does not specify any particular procedures for account supervision. It would require firms to supervise their key business risks but allow them to do so in a way that makes the most sense given the characteristics of their business. Assuming a corresponding approach were taken to SRO requirements, the Code would be a powerful tool for solving the problems that the firms identified under the current system:

1. Because specific procedures are not mandated, the problem of their becoming dated does not arise. Firms could make changes to their procedures promptly when necessary to address changes in the market or their businesses, or when opportunities arise to automate supervision.

2. Each firm could design its procedures in a way that best suits its own business and is best able to prevent and detect the most significant risks.

3. The obstacle to implementing more effective procedures represented by the resources needed to complete and document daily and monthly reviews would disappear. Firms would be free to allocate resources as they saw fit to bring about the most effective outcome.

One criticism of the Code is that the procedures followed by every firm would no longer be identical. Some believe that an advantage of the current regime is that it provides at least one layer of basic compliance activity that is common to all firms. This minimum standard of common compliance procedures is believed to give industry and investors comfort.

Based on what the firms told us, this advantage seems small, and is certainly outweighed by the problems it creates. For example:

- Although the common procedures take a lot of time, some firms rely more on their own risk-based systems (which are not uniform) to prevent and detect misconduct.

- Adherence to a one-size-fits-all system gives investors and industry a false sense of security, because the resources it consumes actually prevents the implementation of more effective systems.

- The mandated procedures and the audits associated with them focus firms on the details of the procedure rather than the desired outcomes.

Conclusions

1. In the area of account supervision, the BC Model would be more effective for investor protection than the current rules.

The current rules emphasize procedures rather than outcomes. The daily and monthly reviews that they require are of some use, but are blunt instruments that trigger reviews of thousands of trades that do not represent significant risk. Much of the most potentially damaging behaviour is best detected through the analysis of trading behaviour patterns. All the firms told us that had they the flexibility to eliminate some transaction-based reviews currently required, they would deploy their resources in favour of risk-based review systems that they have found to be more effective in finding compliance

problems. Under the BC Model they would have this flexibility, and therefore under the Model more resources would be devoted to more effective procedures.

2. **In the area of account supervision, firms would deliver the outcomes mandated by the BC Model.**

Two strong themes emerge from what firms told us about the current system and what they would do under the BC Model. First, firms are motivated, even in the absence of regulation, to ensure that they have effective supervision systems. This is demonstrated by their having developed parallel systems alongside regulatory requirements. They do this for a variety of reasons – they value their business reputation, they consider it to be good business practice, and they want to make sure they have sound defences to civil liability.

Second, firms naturally gravitate to an outcomes-based approach. This is demonstrated by the design of their parallel systems. The focus of these systems is not on the process itself, but how effective it is at preventing and detecting the areas of non-compliance that represent the greatest risks to the business and its clients.

Firms have already adjusted their compliance review processes in ways that would achieve the outcomes mandated by the BC Model, by constructing systems that run in parallel to those required by current rules. Their experience shows that these systems are more effective at detecting serious non-compliant behaviour.

3. **In the area of account supervision, the BC Model would be more efficient for firms than the current regime.**

Firms have created compliance processes that are more effective at detecting serious non-compliant behaviour, but under the current system they are not allowed to substitute those procedures for any part of the detailed daily and monthly reviews. Maintaining a less effective duplicative system is inefficient.

The firms know what they need to supervise and how. Under the BC Model, firms would be free to determine the most efficient means of delivering the compliance outcomes.

2. Marketing Oversight

The current regime has requirements specific to marketing. The BCSC requires that a firm's policy and procedures manual includes a procedure to ensure that the compliance officer review all advertising materials.[17] The IDA requires a dealer to review advertising and marketing materials against a list of seven criteria.[18] There are other scattered references to advertising, mostly dealing with specific disclosures required in advertising materials.[19]

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[17] See BC Policy 31-601 *Registration Requirements*, section 5.6.

[18] See IDA By-law 29.7.

[19] See National Policy Statement 25 *Registrants: Advertising: Disclosure of Interest*, BC Policy 31-601 *Registration Requirements*, sections 4.5, 4.6, and BC Interpretation Note 33-703 *Dealers and Their Salespersons*.

Findings

This summarizes what the four firms who participated in the study told us about how they dealt with the review of marketing materials under the current rules.

1. All of the firms have their compliance departments or senior executives review advertising materials. They would do so whether or not reviews were mandated by regulation, in order to ensure they do not make misrepresentations to their clients.

2. The firms were not clear how much of what they did was as a result of regulatory requirements and how much was their own long-standing corporate practice. (One firm noted that people tend to believe that long-standing policies are mandated by regulation, whether or not that is so.)

3. Reviewing marketing materials is not a significant burden at the small firms. At these firms, the CEO reviews all materials without exception. These firms are happy with their procedures and would make few changes.

4. The two larger firms also thought marketing probably would not change much under the Code. One firm would consider developing a sampling system for certain types of documents among representatives who have proven they know the rules and have a good compliance record. Today it takes two to three days before its compliance department approves or rejects a document. This firm thought that by removing low-risk activity, the wait time would be eliminated for that material and reduced for the remaining documents. The other firm would not take the sampling approach. It said it would be more stringent than necessary, just to fully protect itself.

5. IDA audit standards require firms to retain final drafts of marketing materials (with evidence of review). All of the firms felt that this was unnecessary – the final draft speaks for itself – and just added to their filing and record-keeping costs.

6. IDA audit standards require review of all materials distributed to more than 10 clients. Some firms would use a higher threshold were they allowed to do so.[20]

Analysis

Marketing review under the current regime

All of the firms want their compliance function (or, in the case of the smallest firm, the CEO) involved in the review of marketing materials. Apart from the sampling exception that one of the large firms would make, none of the firms want representatives to be writing advertising copy or individual stock recommendations without this review.

Most firms find the IDA By-law 29.7 criteria fine as far as they go, but they review for other factors as well. This is another example, like account supervision, where specified requirements do not suit all firms. However, unlike the mandated daily and

[20] There is no requirement to support this standard. There is a 10-client rule in the section of Policy 2 dealing with options supervision, but IDA audit standards apply the standard to all securities. We did find one case where the firm's compliance department successfully won a 25-client threshold from the IDA auditors but that threshold is unique to that firm and the other firms we spoke with are still being audited to the 10-client criteria.

monthly reviews mandated under Policy 2, no firm was chafing under the review criteria in By-law 29.7.

The firms do not believe the 10-client threshold for reviews makes sense and would make changes in this area. They would also drop the current practice required by IDA audit standards of retaining draft advertising copy.

The central issue is that firms face criminal, administrative, and civil liability for misrepresentations. Firms also need to watch for defamation and copyright issues. So firms are not going to let representatives prepare and disseminate advertising materials without appropriate oversight. This is the reason that firms do not believe that the fundamental process of reviewing these materials would change, even if By-law 29.7 did not exist.

Marketing review under the BC Model

The BC Model would not regulate marketing and advertising specifically, but there are several provisions that would be relevant if an investor were misled by advertising or other marketing activities. Dealers and advisers must:

- under Principle 1 of the Code, act fairly, honestly, and in good faith and in the best interests of the client
- under Principle 2 of the Code, provide clients with the information necessary to make informed investment decisions, and communicate with clients in plain language
- under Principle 6 of the Code, disclose to clients any information that a reasonable client would consider important to the dealer's or adviser's ability to provide objective service or advice

In addition, the BC Model would prohibit anyone from making a misrepresentation. Contraventions carry criminal, administrative and civil consequences.

A breach of any of the review criteria under IDA By-law 29.7 would also violate these, or other, provisions of the BC Model. However, there is also much conduct related to marketing and advertising that would violate the BC Model but is not mentioned specifically in IDA By-law 29.7. The BC Model is broader because it focuses on the desired outcome – preventing investors from being misled. If firms had this obligation, they could safely be left to choose what to review, particularly since it appears firms' review processes are already driven by this outcome, rather than the content of By-law 29.7.

Conclusions

1. **In the area of marketing oversight, the BC Model would be as effective for investor protection as the current rules.**

As discussed above, any conduct prohibited under the current regime would be similarly prohibited under the BC Model. The Model also has the potential to cover a broader range of misconduct, although in practice the area is reasonably well-covered under existing rules, so this is an example of an area in which the BC Model essentially preserves, and only slightly enhances, the current high level of investor protection.

2. Firms would deliver the outcomes mandated by the BC Model.

The firms did not think that marketing oversight would be likely to change much under the BC Model. They are already following more stringent procedures than those mandated by the IDA, and believe that they would comply with the requirements of the BC Model using their existing procedures.

3. The BC Model would be more efficient for firms than the current regime.

The firms identified some small potential efficiency gains, both related to audit practice.

B. Managing Conflicts

1. Generally

Conflicts of interest affect many aspects of the business of trading and advising in securities. However, there is no current provision in securities legislation or SRO rules that deals directly with conflicts of interest generally.[21] The current regime regulates some specific types of conflict of interest through conduct prohibitions or restrictions, or by prescribing disclosure. These provisions are generally found with the relevant context, and so are scattered throughout the legislation and rules. Many areas of conflict are not specifically addressed in the current regime.

Under the BC Model, all of these requirements would be replaced by Principle 6 of the Code of Conduct. This Principle, and other parts of the Code, are designed to cover not just the areas of conflict covered by the current regime, but conflicts generally. This is because we do not believe that the system can ever adequately deal with conflicts of interest by attempting to create a rule for every specific situation.

The first rule under Principle 6 requires dealers and advisers to resolve all conflicts of interest in favour of the client using fair, objective, and transparent criteria. Other requirements of the rules under Principle 6 are to:

- develop conflict of interest procedures and disclose them to the client
- disclose promptly to the client any information that a reasonable client would consider important in determining the dealer's or adviser's ability to provide objective service or advice
- take certain measures when acting as an underwriter, or when providing analyst services

In addition, Principle 2 of the Code includes two rules that would require dealers and advisers to disclose conflicts when dealing with clients. One requires dealers and advisers to disclose all facts that a reasonable person would consider important to the

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[21] Section 14 of the *Securities Rules* requires that registrants deal fairly, honestly, and in good faith with their clients. Broadly interpreted, this provision could be considered to impose a general obligation to resolve all conflicts of interest in favour of clients. It has not been generally thought of doing so, and regulators have rarely made use of it for this purpose, however. Section 14 is carried forward in Principle 1 of the Code.

business relationship. The other requires dealers and advisers to give clients in plain language the information necessary to make informed investment decisions.

The broader approach under the Code would cover many areas of conflict not covered under the current regime. For example:

- full details of how firms and individuals are compensated, and by whom, including front-end and deferred sales charges on mutual funds, trailer fees, sales incentives, and trading commissions for both stocks and fixed income securities
- material details of a broker's track record, regardless of whether the client proactively requests this information
- how a mutual fund dealer's registration inherently constrains it from offering many types of securities that might be just as, or more, suitable for their clients

2. Analyst Conflicts

The conflict of interest faced by analysts employed by investment dealers has been the subject of much recent debate and regulatory activity. Investment dealers who carry on both investment banking and security analysis services are in the business of both telling people what to buy and creating products available for purchase. As a result, there is an inherent danger that their reports and recommendations may not be entirely objective, candid, or independent.

Until recently, the current regime did not specifically regulate this area (although the rule requiring a dealer to deal fairly, honestly and in good faith with its clients would seem to be a useful tool to deal with it). In the United States, the National Association of Securities Dealers, Inc. created NASD Rule 2711 *Research Analysts and Research Reports*. This rule is now in force and applies to all research distributed in the US. This extends its reach to many Canadian dealers because they provide research to US affiliates for use in the US. NASD 2711 defines the "Chinese wall" between research and investment banking, requires supervisory procedures, restricts trading and compensation schemes of research analysts, and mandates specific disclosure.

In Canada, the IDA has just adopted Policy 11 *Analyst Standards*. Policy 11 covers the same ground as NASD 2711, but adds several requirements (and omits others). Although not in force when we interviewed the four firms, it was out for comment as a proposal. The firms were familiar with it and had spent time thinking about how to incorporate it into their operations.

Findings

This summarizes what the four firms who participated in the study told us about the impact of the new analyst conflict rules on their operations.

1. One of the large firms has rewritten its policy to meet the requirements of NASD Rule 2711 and IDA Policy 11. Through this process, it has concluded that many of the new requirements do not address real problems yet require significant work and supervision.

2. All but one of the firms face compliance with both NASD Rule 2711 and IDA Policy 11. These firms object to having to comply with two different policies that are intended to deal with the same issue. They ask why they need to comply with so many rules exclusive to IDA Policy 11 if they are already subject to NASD Rule 2711.

3. Two firms pointed out that although IDA Policy 11 concentrates on research reports and public comments made by analysts, it also applies to all recommendations made to clients. Therefore, they say, a firm's policy also needs to cover the other situations in which clients receive recommendations from analysts, such as phone calls and e-mails from their representatives. The Policy is unclear on the disclosure mechanism in these situations, and the firms noted that reading the mandated disclosure orally to clients could create distrust disproportionate to the real conflicts.

4. There are several requirements in IDA Policy 11 that firms felt strongly could be regulated in a simpler manner. These concerns are similar to those they expressed about IDA Policy 2 (see *Account Supervision)* – rules imposing specific requirements that will not accommodate firms' differing operational requirements and that are destined to become dated. For example, the Policy 11 public speaking requirements apply to a much larger group than NASD Rule 2711. NASD Rule 2711 covers public statements only by the analyst; it imposes no requirements on other employees of the firm.[22] IDA Policy 11 applies to any employee who comments on the merits of an issuer.[23]

5. The firms recognized that although some thresholds may initially be useful to industry as a way of understanding when they will be offside with regulators, over time these thresholds will become both arbitrary and onerous in various circumstances, without providing any real improvement in investor protection. Firms would have preferred to see the desired results expressed as principles, with thresholds expressed as part of guidance to illustrate what the IDA believes is a reasonable starting point.

6. IDA Policy 11 requires the dealer to explain the rating system used by the analyst and to publish a quarterly distribution of ratings. The firms pointed out that this information was not likely to be useful to the public, and could be misleading. They said that disclosing a quarterly distribution of ratings implies there is "proper" allocation of ratings to which the disclosure could be compared, but there is not. For example, one firm said that any issuer it covers receives a "sell" rating only once – after that the firm discontinues coverage. The firms also said that analysts tend to cover the firms whose securities are most suitable for the firm's clients. Not all firms seek the same type or distribution of investor, so the portfolio of issuers a firm covers and the nature of its business will influence the distribution of a firm's ratings.

7. If an analyst visits material business operations of a covered issuer, IDA Policy 11 requires the dealer to state what material operations the analyst has seen and who paid for the visit. The firms questioned how material this information is to an investor

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[22] The analyst must disclose personal household and firm shareholding status (if any), whether the issuer is a client, and personal household employment relationships with the issuer (if any).

[23] The employee must cite any report that meets the requirements of Policy 11, or state that such a report does not exist.

(particularly if the firm, not the subject company, paid for the trip).[24] Firms were also unclear on the meaning of "material operations". The firms said that it is not unusual for a business to rely on more than just one or two locations, even if it is a manufacturing or capital-intensive business.

8. All of the firms were very concerned about the cost implications of IDA Policy 11 and NASD Rule 2711. Shareholding disclosure requirements for firms and their affiliates will result in large systems costs because of the complex systems necessary to capture the required real time data from all of their business units. For some firms, these units are so removed from one another that this will be the only formal system connecting them. Depending on the circumstances of each firm, firms expect the costs to range from $200,000 to several million dollars. For example, one US firm spent US$10 million developing a system to track the data it needed to comply with NASD Rule 2711. Although one of the firms we interviewed was fortunate enough to buy that system for just C$200,000 (although it expects to spend at least another $25,000 per year to populate it with market data), another has spent much more. All firms will have to build or buy these systems regardless of size, if only to demonstrate that they do *not* meet the thresholds of one percent of any share class. (The small firms we spoke with did not expect their holdings would ever reach a one percent threshold.)

9. One of the firms has no underwriting business and felt it unfair that it should have to comply with the new rules. This firm already has policies that restrict pro trading and deals with communications between analysts and the sales force, yet it is having to spend several thousand dollars on legal fees to rewrite their policy to comply with IDA Policy 11.

10. The firms identified the significant resources consumed designing a system to meet all of the requirements of NASD Rule 2711 and IDA Policy 11. One firm said it took 9 person-months of lawyer time, 5 person-months of compliance manager time and another 3.5 person months of other senior professional time, including the lead institutional compliance manager and the head of research.

11. One firm drew our attention to the introductory language in the "Guidelines" section of IDA Policy 11. The Policy is divided into two sections, "Requirements" and "Guidelines". The usual interpretation of such a division would be that the first is required and the second is interpretive or voluntary in nature. However, the "Guidelines" section opens with these words: "In addition to the above requirements, when establishing policies and procedures as referred to under requirement 1 of IDA Policy No. 11, *Members must comply with* the following best practices, where practicable".[25] The firm objected to requirements being disguised as guidelines, and was of the view they did not belong in the policy at all.

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[24] The policy also does not deal with shared costs. For example, what if the firm paid the airfare, but the covered issuer paid for ground transport and hotels? One firm pointed out that sometimes they pay for trips, but if the issuer becomes a client, those travel expenses are absorbed by the issuer.

[25] Our emphasis.

Analysis

Regulating analyst conflicts under the current regime

The firms seriously question whether IDA Policy 11 (or, for that matter, NASD Rule 2711) will address the real issue. The Introduction to the Policy states:

> This Policy establishes requirements that analysts must follow when publishing research reports or making recommendations. These requirements represent the minimum procedural requirements that Members must have in place to minimize potential conflicts of interest.

Similarly, the IDA press release announcing Policy 11 said, "Policy 11 addresses potential conflicts of interest regarding research analysis through a combination of prohibitions and disclosures."

The issue, then, is conflicts of interest associated with a firm in the investment banking business that provides securities analysis services. In the high-profile cases in the US that highlighted these concerns, these conflicts gave rise to problems such as the following:

- an analyst rated several stocks as strong buys, yet in internal correspondence described the stocks as "crap"
- analysts over-rated stocks of corporations that were the firm's investment banking clients or potential clients,
- analysts helped sell banking work, and promoted upcoming issues in road shows

Both NASD Rule 2711 and IDA Policy 11 address the issue in the same way that IDA Policy 2 deals with account supervision: they prescribe specific procedures and disclosures on the assumption that if these procedures are followed, the consequences of these conflicts will be eliminated, or at least mitigated.

However, neither the NASD nor the IDA have published any research that demonstrates that these rules, if followed, will have that result. The firms we interviewed are skeptical. As noted in the findings, they doubt that much of the disclosure required is likely to be either relevant or of use to investors.

The approach chosen also carries the risks that have befallen IDA Policy 2 – a series of fixed requirements that will not stand the test of time, resulting in an onerous compliance burden that has little or no benefit to investors.

However, even for those who believe that the approach taken by NASD Rule 2711 and IDA Policy 11 is on the right track (we found none among the four firms), it is more difficult to defend requirements in IDA Policy 11 that exceed those in NASD Rule 2711.[26]

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[26] In some areas, IDA Policy 11 is less onerous than NASD Rule 2711. It is less stringent on how firms must document the relationship between research staff and the investment banking arm, on what sections of a draft report the analyst can show a subject company, and on the receipt of pre-IPO shares by analysts. Some US requirements have also been omitted from IDA Policy 11: front page disclosure, prescribed ratings terminology, and the use of a price chart.

The firms were particularly critical of this aspect of IDA Policy 11. The Policy has two requirements not present in NASD Rule 2711 that deal with conflict issues:

- Members must pre-approve analysts' outside business activities.
- Members must state what material operations the analyst has seen of the issuer and who paid for the visit. This was discussed in the findings above.

However, IDA Policy 11 also has another eight requirements not present in NASD Rule 2711 that have nothing to do with the conflict of interest issue that is purportedly the reason for the Policy. Instead, they are new rules governing the performance of the analysis function itself:[27]

- Members must publish notice of their intention to suspend or discontinue coverage of an issuer.
- Members must collect CEO and Research Director signatures certifying that their analysts comply with AIMR. Many firms already collect this as employees start at the firm. Signing an annual certificate is seen as a compliance burden with limited investor protection value.
- Members must add disclosure to independent third party reports that the firm distributes if the third party does not abide by NASD Rule 2711 or IDA Policy 11. The Policy is not clear whether this applies to reports sent to clients by representatives on their own initiative as part of client service. More to the point, firms rightly question where the potential conflict lies in giving research to clients when the third party report's recommendations have no potential conflicts with the rest of the dealer, and the individual broker is only sharing broadly available information with clients.
- Members must cite any reliance on third-party sources.
- Reports must distinguish between facts and analyst's assumptions and opinions.
- Reports must meet minimum "standards of research coverage", which means maintaining current financial estimates and recommendations.
- Members must use specific securities terminology and provide a glossary where necessary.
- Members should publish reports electronically to allow simultaneous access.
- Members should require analysts to be CFAs.

That these rules do not relate to the conflict issue was not lost on the firms, one of which objected to their inclusion in Policy for exactly that reason. Furthermore, these new rules mandate specific requirements, yet what constitutes good research practice is always evolving.

Meanwhile, IDA Policy 11 departs significantly from NASD Rule 2711 provisions that define "Chinese wall" measures between analysts and the investment banking arm. Clarifying the duty of firms to actively manage this conflict would seem fundamental to solving the problem purportedly being addressed by the policy, but this key outcome is mentioned only as the last rule of the "Guidelines": it says that "no policies or

[27] The last six items in the list are in the section of the Policy entitled "Guidelines", but given that the Policy says that members must comply with them, we have treated them as requirements.

procedures will be approved . . . unless . . . they address the relationship between the investment-banking department and research department."[28]

In other areas where IDA Policy 11 has requirements that correspond to US requirements, it has enhanced them. For example:

- NASD Rule 2711 applies to equity reports; IDA Policy 11 applies to both debt and equity reports.

- NASD Rule 2711 requires the report to disclose whether research analysts or members of their household are officers or directors of the subject company; IDA Policy 11 prohibits firms from covering the issuer under these circumstances, or if the household member is merely an employee of the issuer. It also prohibits coverage if the supervisory analyst is an officer or director of an issuer. Under IDA Policy 11, the report must also disclose whether any firm partners, officers, directors, agents, or employees (other than analysts) are officers, directors, advisors, or employees of the issuer.

  Firms felt this requirement to be needlessly different from NASD Rule 2711 and that collecting the information would be burdensome. They have some of this information for registered employees, but the rule covers non-registered employees as well and even the data they already have is not in a searchable database. However, as with IDA Policy 2, the real problem here is ineffectiveness. Under IDA Policy 11, relationships that present no practical risk of conflict would end up triggering the prohibition or disclosure requirement. A more principles-based approach would catch all material relationships, including situations not caught by Policy 11 that present a real risk of conflict, such as the firm CEO's spouse acting as a director of a covered issuer.

- NASD Rule 2711 allows firms to use their website to publish disclosure when they are covering six or more issuers in a single report. NASD Rule 2711 also requires a distribution of ratings be put on their report. IDA Policy 11 has this same provision, but mandates other uses of the website. It requires that the distribution of ratings be posted on the website, requires firms to publish its research dissemination policies and procedures on their websites, and states that firms should distribute reports through their websites for simultaneous distribution.

The IDA has not published any research showing why these additional and enhanced requirements are necessary. They will apply to every report coming from Canada, but not to comparable US research. The firms identified many of these as costly additions, yet whether they will give investors decision-changing information has not been established.[29]

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[28] Policy 11 does deal with investment banking's role in research, but only by requiring policies that reasonably prevent them from influencing recommendations. The minimum standards listed in the rule cover only a small part of the interaction between the analyst and investment banking functions.

[29] The responses to an OSC inquiry on analyst policies in September, 2002 shows that firms were already actively dealing with the analyst conflict issue before the emergence of IDA Policy 11, even in its draft form.

Regulating analyst conflicts under the BC Model

The Code of Conduct deals with analyst conflicts in two rules. The first, paragraph 5 under Principle 6 – Conflict of Interest, says:

> When providing security analyst services, develop, establish, and enforce conflict of interest policies that adequately address the conflicts of interest that analysts face within your firm.

The second, paragraph 5 under Principle 7 – Compliance Systems, requires firms to "separate analyst functions from the firm's underwriting functions."

These are in addition to other rules in the Code that would be relevant to analyst conflicts even if the above rules were not included.[30]

Because the analyst conflict issue and the regulatory response is new, it presents a perfect opportunity to consider how best to motivate a long-standing industry to take a fresh look at its business practices. Will the detailed rules in NASD Rule 2711 and IDA Policy 11 prevent firms from issuing misleading research to support their investment banking work? (We hope so, because as the firms pointed out, the associated compliance costs are very high.)

The fundamental issue is one of managing conflicts. This is what the Code addresses directly, rather than focusing on prescribed behaviours that, even if complied with, may or may not be effective at dealing with the issue.

The Code's approach to managing conflicts would have the same benefits identified in the analysis of IDA Policy 2. Rather than focus industry on compliance with a host of detailed requirements, the Code sets a clear expectation that firms deal with the associated conflicts, act in the best interests of their clients, and keep them appropriately informed. The firms understood this approach and thought it would likely be more effective at addressing the real conflicts inherent in the analyst function. Investors would be better protected as a result: firms would develop conflict of interest policies relevant to their business and disclose irresolvable conflicts to their clients. This approach allows firms to develop their own solutions to areas of concern with regard to their own operational characteristics and risk profile. It would further allow firms with minimal conflict risk to deal with the issue commensurately.

The IDA Policy 11 requirement that firms disclose whether analyst pay is based on investment banking revenue highlights both the differences between the two approaches and the firms' skepticism about its long-term effectiveness.[31] Most firms do not charge separately for analyst services. Therefore, the firms thought it would be hard to argue that salaries paid to analysts are not tied, at least in part, to profitable areas of the firm, including investment banking. Because all firms believe they would be forced to state this, the disclosure will be meaningless. Instead of focusing on cross-subsidized analyst divisions as a putative symptom of conflict, firms thought it would be more constructive to focus on disclosure of the firm's system for dealing with the conflict.

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[30] See Principle 1sections 1,4; Principle 2, sections 1,2; and Principle 6, sections 1-3. Arguably these rules cover the matter adequately and any specific mention of the analyst function could be handled through guidance.

[31] This rule is separate from another rule that prohibits compensation based on specific investment banking transactions.

Conclusions

1. The BC Model would be as or more effective in regulating analyst conflicts of interest than the current rules.

Analyst conflicts is an area that provides a good example of both how the Code, with significantly streamlined rules, would produce the same or better outcomes, and how a Code can address new issues affecting long-standing industry practices without adding new rules.

One argument in favour of regulation that relies more on principles and less on rules is that it focuses industry on real problems, rather than the details of regulation. Our observation of the firms' reaction to IDA Policy 11 (and NASD Rule 2711, for that matter) seems to bear this out. Their focus was entirely on the systems and procedures they would have to develop to comply with the new requirements.

Because the analyst conflicts issue generated new regulation that was being developed and adopted while our study was underway, it gave us a clear example of how a rules-based system adapts to change, relative to how the Code would. Both regulators and dealers expended significant effort creating and commenting on the rules. Then each firm had to learn the new rules, implement new lines of compliance systems, and cope with the interruption these rules create in the firm's core business. Under the Code, the matter could have been dealt with by using existing principles. By adding one additional outcome (section 5 of Principle 6) and mandating a separation between analysts and investment banking (section 5 of Principle 7), a new standard of behaviour would have been established in an area not originally contemplated.[32]

While new market issues will arise that warrant a change in regulatory standards, a code of conduct is better positioned to use existing tools to improve industry practice. One firm recognized the need to beef up its analyst procedures to comply with the Code, but said the disclosure would look different under the new requirements and they would be better able to design the necessary processes into their existing system than they can under IDA Policy 11. The firms told us that had they been allowed to focus on the analyst conflict issue itself, rather than the mandated rules, they would have developed policies that were more efficient and more likely to protect investors.

2. In the area of analyst supervision, firms would deliver the outcomes mandated by the BC Model.

IDA Policy 11 is new, so there has not been time for firms to design the work-arounds and parallel compliance systems they may find necessary to cover risk in this area, as they have done with Policy 2. Yet even before the regulatory focus fell on analyst policies, firms knew analysts had conflicts and had policies in place to disclose holdings, relationships with the investment banking arm, and vested interests of the specific report authors. They also had trading rules for analysts.[33]

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[32] As noted above, even this may not be necessary. For example, the guidance that appears under section 5 of Principle 6 could be moved to section 3 of the same Principle, which is broad enough to cover the area of analyst conflicts.

[33] Interestingly, no research was published, in connection with the release of IDA Policy 11,to show that these existing practices were ineffective.

Bringing those requirements in line with the Code would allow firms to work from their existing policies. This would result in a variety of solutions, all focused on the single goal of achieving the desired outcome.

3. The BC Model approach to analyst conflicts would be more efficient for firms than the current regime.

There has been no comprehensive study of the costs associated with the analyst conflict rules, but the anecdotal information we received from the four firms is disquieting. Probably the most expensive component of the new compliance costs is the system that tracks shareholdings (and, under IDA Policy 11, holdings of debt securities), yet the firms do not believe that the additional information these systems collect is useful to investors. Under the Code, they would not have chosen this particular means of addressing the conflict issue, and would have avoided those costs.[34]

In addition to the costs already mentioned of developing systems to track share holdings, firms must also have systems to detect whether any of their staff have a relationship with a covered issuer, who makes public comments, and site visit costs paid by covered issuers.

Firms created compliance processes for account supervision that are more effective in detecting serious non-compliant behaviour, and would meet the requirements of the Code. Given the similarity in how detail is built into the new analyst conflict rules, there are strong reasons for believing that mandating the outcomes in the Code's would yield similar efficiency savings.

C. Audit, Compliance and Enforcement

1. Audit Practice

We have seen that the effectiveness of regulation is increased and its burden reduced if the content of regulation favours an emphasis on outcomes rather than processes. This phenomenon is echoed in the administration of the regulatory system. No matter how outcomes-focused the rules may be, if market participants are audited using a process-oriented approach, the potential benefits of content design will be lost.

Findings

The four firms pointed out that even though the relevance of transaction-based reviews has diminished in practical importance over the past few years, during the same period, audit standards for these reviews have grown more stringent and less flexible. This section describes the audit experience of the four firms related to the IDA's account supervision and marketing rules.[35]

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[34] Supporters of this aspect of the new requirements might fairly ask why the firms' opinion on this issue should be determinative. We suggest that those who propose new rules with high associated costs – not those who will shoulder those costs – should bear the onus of demonstrating effectiveness.

[35] IDA Policy 2 and IDA By-law 29.7, respectively. See discussion earlier in this paper in sections III. A. 1 and 2. IDA Policy 11 *Analyst Standards*, also discussed earlier, is new; no firm has yet been audited for compliance with this Policy

1. The firms told us that IDA audit standards emphasize rote compliance with the letter of the rules. Auditors report deficiencies whether or not the deficiency in question betrays any inappropriate patterns of behaviour in the firm's compliance practices, or any inherent shortcoming in the firm's compliance system. An example lies in the area of assigning risk profiles to individual securities. If a firm considers a certain stock to be, say, medium risk, but the IDA auditor considers it high risk, the firms tell us that the auditor's opinion prevails. When this happens, it means that some clients have stocks in their portfolio that exceed the stated risk parameters in the know your client (KYC) form. The firm then must have its representatives ask those clients either to revise their KYC forms, dispose of the impugned stocks, or confirm they wish to continue holding the stock even though it falls outside their documented risk profile. This whole process involves significant time and effort on the part of the auditor, the firm, the representatives, and the client. Yet it reveals no fundamental flaw in the design or application of the firm's compliance system.[36] More importantly, by focusing unduly on the suitability of a specific security, this approach fails to assess the suitability of the portfolio as a whole.

2. One firm using pattern-based reviews told us that when something is really worth looking at, "it usually jumps out at you like a sore thumb". However, given the IDA audit standards' insistence on strict compliance with the transaction-based methodology, the firm applies it to avoid being cited for non-compliance.

3. Firms also told us that the audit process adds requirements not found in the rules themselves. For example, IDA audit standards require firms to show physical evidence of the daily and monthly review process, a requirement not contained in Policy 2.

   It may be reasonable to expect firms to have some records showing that they are following compliance procedures, but firms point out that the IDA audit standards require paper records of compliance, even if the firm has electronic systems to track daily and monthly review activity. The firms also say that the audit standards go well beyond merely confirming that the firm did the reviews -- they prescribe the form of record keeping and detail procedural requirements, which include signing and dating the blotter and maintaining evidence of inquiries based on these reviews and of responses to the inquiries.

4. Facing this audit approach, firms expect their compliance officers to have encyclopedic knowledge of IDA rules. However, as the firms pointed out, this is often not enough, because the IDA uses extensive audit checklists that are not available to industry.[37] For example, IDA audit standards use a 105-page checklist to audit sales compliance. Given that the IDA requires firms to comply with much through the audit process that is not apparent in the underlying requirements of the policies, it is not uncommon for firms to be cited for deficiencies arising from audit checklist items about which the firm was not aware. The firms told us that the risk of

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[36] This approach may also tempt representatives to try to push the boundaries with their clients about their documented risk tolerance, because the higher the risk level shown on the KYC, the less likely the representative is to have to deal with these kinds of audit issues.

[37] The IDA says it does not make its audit checklists available to firms because they do not want firms to systematically disregard areas not covered by the checklist or to develop rote answers to audit questions.

citation under detailed audit standards is a strong incentive to follow the policy to the letter.[38]

5. IDA By-law 29.7 related to marketing materials is another area that the firms drew to our attention as an example of audit standards adding regulatory burden. As noted in the earlier discussion, the firms had no real concerns with By-law 29.7 itself, but had two concerns about the auditing standards surrounding it.

   First, the audit standards require that a designated officer review advertising and market letters if they are sent to more than 10 clients. Although Policy 2 contains no such requirement for securities in general, just for options, the IDA nevertheless audits to that standard for all securities. The larger firms thought this threshold was too low in their circumstances. One of the firms, with some difficulty, obtained permission to raise the threshold to 25 clients, but the IDA still audits to the 10-client rule for all other firms.

   Second, IDA auditor standards require firms to keep final drafts of all these materials in paper form to prove they were reviewed before publication.

6. Firms also said that the IDA audit standards impose inefficiencies. For example, one firm designed an automated system to complete KYC forms online and store all the elements in a database. This makes the relevant information readily available to representatives for dealing with clients, and to the firm's compliance office for doing reviews. However, IDA audit standards require the firm to use manual signatures. The firm therefore had to create another system to print out the forms, move them physically through its office to get the required signatures, and then scan the forms into a second electronic database. This parallel system was created just to gather internal signatures because electronic signatures do not satisfy the audit standards. (Interestingly, client signatures are not required for account opening forms unless they are option accounts, margin accounts, managed/discretionary accounts, or KYC-exempt accounts.)

Analysis

Audit practice under the BC Model

Under the BC Model, firms would make more independent decisions and, although informed by BCSC and SRO guidance, would be ultimately responsible for those decisions. In this environment, the audit process would checks whether the firm's compliance system delivers the outcomes mandated by the Model. Put another way, audit standards under the BC Model would seek to answer the question, "Does this firm have systems that are likely to prevent and detect the risks that the Code and the other rules in the BC Model are intended to address?". The focus shifts from checking off a list of specified procedures to reviewing processes and applying judgment to determine whether the firm has a credible compliance system, and a track record of successful prevention and detection of wrongdoing.

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[38] For example, the module for discretionary and managed accounts has 46 audit points for Regulation 1300, which has only 21 requirements.

Using the issues raised in the Findings, these are examples of how audit standards would be designed and applied under the BC Model:

- Audit standards would concentrate on the areas of most significant risk to clients and the market, using traditional risk assessment models.[39] Audit standards would also be concentrated on firms identified as higher-risk, or business models or specialties with inherently risky characteristics. No firm or business practice would be immune from audit because no firm would know ahead of time which medium or low risk issues would be covered in their specific audit.

- Audit standards would recognize that there are many routes to a given outcome, so that firms would not be required to use the same methodology in each case. It is a deliberate design feature of the BC Model that firms be given the latitude to create their compliance systems in ways that suit their operating characteristics, as long as the outcomes in the Model are met. The audit standards would recognize that flexibility by asking firms to explain how their processes meet the requirements of the Model. We do not plan to impose additional requirements through the audit process.

- Market participants would know the standards against which their conduct will be audited. Accompanying the BC Model will be comprehensive guidance, which will be kept fresh through consultation with industry (and, by dealing with issues arising from the audit process). Firms that focus on the outcomes mandated by the Model and the interpretation presented in the guidance will be unlikely to encounter surprises in their audits.

- The corollary of the previous paragraph is that "best practices" will not be the standard required in all cases by the audit. "Best practice" is an elastic concept – what is considered best practice today may be considered inadequate or over-reaching tomorrow. The goal will therefore be to ensure that all firms have standards that will produce the mandated outcomes, whether this happens through application of the so-called "best practices of the day," or by some other means. This approach avoids the risk of enshrining a set of practices into audit standards that may be seen as "best" when adopted, but become superseded by experience. We are skeptical that any set of mandated audit standards can keep pace in real time with changes in perception about what constitutes "best" practice.

  Research by the U.K. Financial Services Authority also suggests that the burden imposed on industry by holding all players to "good" practice is reasonably low, because most of industry, at any given point in time, is already following good practice. However, the cost of imposing "best" practice is extremely burdensome, because at any given point in time very few are following it (probably because "best" is not always necessary).[40] In the context of the BC Model, practices would only be considered "good" if they delivered the outcomes required by the Code. As noted earlier, much of current practice would meet this standard.

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[39] These generally weigh both the likelihood of each given event and the severity of its consequences to develop a matrix of high, medium and low risk areas.

[40] Alfon, I., and Andrews, P., "Cost-Benefit Analysis in Financial Regulation: How To Do It and How It Adds Value", 1999, Financial Services Authority (UK), *FSA Occasional Paper Series 3*.

2. Compliance Reviews Under the BC Model

One way we tested the BC Model's effectiveness as a compliance tool was by conducting simulated examinations. Commission staff examiners used the results from previously completed examinations of registered firms, and re-did the examinations using the BC Model instead of the current rules.

The simulated examinations were chosen because the issues they raised typify the most significant issues generally encountered in examinations. They covered two portfolio managers, a scholarship plan dealer, an investment counselor, and two mutual fund dealers.

Our examiners found that the BC Model was as effective as or more effective than the current regulatory system in addressing the non-compliant actions of firms and their employees.

Case 1 – Compliance officer unfamiliar with securities regulations and the firm's policies and procedures manual

Findings

The compliance officer had an inadequate knowledge of current securities legislation and lacked the supervisory skills needed to question unusual and irregular trading activities at the firm. The compliance officer was unaware:

- of policies and procedures in the firm's procedure manual
- of the compliance officer's duty list as documented in the firm's procedure manual
- that the compliance officer was responsible for supervising and reviewing the work of the branch managers and president of the firm

Basis for action under the current legislation

Commission staff found that:

- The firm violated section 44(1) of the Securities Rules, which requires a firm to establish and apply written prudent business procedures for dealing with clients. In this case, the firm was not applying the procedures set out in its compliance manual because its compliance officer either did not know the rules existed or did not understand them.

- The firm violated section 65 of the Securities Rules, which requires a firm to hire a compliance officer "to ensure compliance" with legislation and internal firm policy by the firm's directors, officers and employees. In this case, the compliance officer was not "ensuring" that members of the firm were complying with securities legislation.

- The firm violated section 2.5.2 of the MFDA Rules, which requires a firm to hire a compliance officer to promote the adherence by the firm of MFDA rules and firm policies.

Basis for action under the BC Model

The relevant rules in the Code are sections 1 and 2 of Principle 7, which require firms to have effective compliance and risk-management systems and a competent person to operate them. Commission staff found that under the BC Model:

- The firm would have violated section 1 of Principle 7. This section requires that a firm have an effective compliance system to ensure compliance with securities regulations and the firm's own internal policies. The firm had a compliance system on paper, but the lack of a trained and proficient compliance officer to administer the system was a failure of the system as a whole. In this case, the firm's compliance system could not be said to be "effective" because the compliance officer was untrained and lacked the ability to carry out his role in the firm's compliance system.

- The firm would have violated the requirement in section 1 of Principle 7 to have an effective system to manage their business risks. The compliance officer's lack of knowledge actually increased the business risks to this firm.

- The firm would have violated section 2 of Principle 7, which requires the compliance officer to possess the technical competence, independence, and experience necessary for the performance of the compliance function.

Conclusion

Commission staff found that the BC Model would deal with this issue just as effectively as the current legislation.

Case 2 – Irregularities in Know Your Client (KYC) forms

Findings

The firm had no KYC form completed for many of its clients and management had not reviewed or approved the KYC forms that did exist.

A representative completed 800 KYC update forms in a two-month period but did not review each form as required – the representative simply updated the date on the current KYC form for each client instead of doing an actual KYC review.

The firm used pre-signed blank KYC forms in some client files. These were used by representatives to conform to a client's new circumstances when a client's financial picture or risk tolerance changed.

KYC forms were not kept in client files – they were stored in ring binders in the compliance officer's office so he could do trade reviews. The firm sent all KYC forms older than five years off-site, even if a new KYC form had not been completed.

Basis for action under the current legislation

Commission staff found that:

- In failing to complete KYC forms, update them properly, and use them when determining suitability, the firm violated section 48 of the Rules, section 2.2.1 of the MFDA Rules (these provisions require the firm and representative to know about their clients' reputation, creditworthiness, and investment objectives), and section 2.2.4 of the MFDA Rules (which require KYC forms to be updated to reflect material changes).

- In failing to review the KYC forms, the firm violated section 47 of the Rules which requires a registrant to designate a compliance officer or branch manager to approve the opening of new client accounts.

Basis for action under the BC Model

Commission staff found that under the BC Model:

- In failing to complete KYC forms for clients, to update them properly, and use them in determining suitability, the firm and its representatives would have violated sections 1 and 2 of Principle 5 of the Code, which essentially continues the requirements of section 48 of the current Rules.

- In failing to review the KYC forms, the firm would have violated section 1 of Principle 7, which requires a firm to maintain effective systems to ensure compliance with the Code and to manage the risks associated with its business. The firm had no system to ensure that its representatives were following good KYC practice as required by the Code. It also did not have a system to protect it from the risks of regulatory and civil actions arising from making unsuitable trades for its clients.

- The preparation of falsified KYC updates violates section 1 of Principle 1, which requires firms and registrants to act fairly, honestly, and in good faith and in the best interests of their clients.

- The practice of keeping pre-signed KYC's on file would violate section 1 of Principle 7 on the basis that it creates an opportunity for misuse of the forms, and therefore would not adequately manage the associated risks. If misuse actually occurred, it could also violate any one of a number of provisions under the BC Model, ranging from section 1 of Principle 1 (fair dealing with clients), to sections 1 and 2 of Principle 5 (know your client and suitability), to a contravention of the prohibitions against misrepresentation, fraud or unfair trade practices.

Conclusions

Commission staff found that the BC Model would deal with this issue just as effectively as the current legislation.

Case 3 - Ambiguous statements

Findings

The firm did not inform the clients who paid for financial plans that the financial plan and the implementation of that plan were two separate services. Clients may have concluded that they had to have their financial plans executed at the same firm that prepared the plan.

The firm advertised offshore investments, guaranteed investments, and insurance-related products such as segregated funds. It was discovered that the firm's compliance team had failed to enquire of its representatives the exact nature of the securities that were being advertised.

Basis for action under the current legislation

Commission staff found that:

- The firm's omission to state in its financial plans that clients were free to have the plans implemented elsewhere may have been a misrepresentation, and therefore a violation of section 50(1)(d) of the Securities Act (prohibition against misrepresentations).

- If the firm's representatives were found to be selling securities that they were not licenced to sell, they would be in breach of one of their conditions of registration.

Basis for action under the BC Model

Commission staff found that under the BC Model:

- The firm would have violated section 2 of Principle 2, which requires firms to provide clients with the information necessary to make informed investment decisions. Clients who believed that their financial plans would have to be implemented by the registrant who prepared it would not have the information necessary to make an informed investment decision.

- The firm would have violated section 1 of Principle 2, which requires firms to keep clients or prospective clients informed of all facts that a reasonable person would consider important to the business relationship. This is not the case when the client does not have accurate or complete information about the securities that are available for sale or about which firms the representative represents. Nor would it be the case if the client believed that the business relationship with the dealer required the client to implement the financial plan with that dealer.

- The firm would have violated section 1 of Principle 7, referred to earlier. If the compliance officer was unaware of the advertising activities of the firm's representatives, the firm's compliance system was not effective to ensure compliance with the Code and to manage the risks of the business.

Conclusion

Our current legislation does not specifically require firms and their representatives to inform clients that the person who produces a financial plan need not be the person who implements it. Neither does the BC Model, but it does have provisions in Principle 2 that address the issue. Commission staff therefore found that the BC Model would deal more effectively with this issue than the current legislation.

Case 4 – Misleading use of titles

Findings

In communications with clients and potential clients, the firm's sales representatives were using one or more of the following titles: Investment Broker, Financial Advisor, and Financial Planner.

Basis for action under the current legislation

Commission staff found that the firm and its representatives violated section 11 of the Rules, which says that a registrant must not use a business title that is likely to deceive or mislead the public about the proficiency and qualifications of the registrant. The titles "Investment Broker" and "Financial Advisor", are typically used to refer to those registered in the investment dealer and adviser categories, and who have proficiency and qualifications that were not possessed by these representatives. "Financial Planner" is a title used by those who have completed any one of a number of programs requiring specified educational criteria. Some of the representatives using the titles in this example had not met the criteria associated with those titles. Therefore, using those titles was misleading to the public.

Basis for action under the BC Model

Commission staff found that under the BC Model:

- The firm and its representatives would have violated section 1 of Principle 2 of the Code of Conduct, which would require them to keep their clients informed of all facts that a reasonable person would consider important to the business relationship.

- The firm and its representatives would have violated the prohibition in the BC Model against making misrepresentations. A misrepresentation in this context includes untrue or omitted information that a reasonable investor would consider important in making a decision to enter into a trading or advising relationship.

- The firm would have violated section 1 of Principle 7 because its compliance officer did not know that some of the representatives who were holding themselves out as "Financial Planners" did not meet the required criteria for such a designation.

Conclusions

Commission staff found that the BC Model would deal with this issue just as effectively as the current legislation.

Case 5 – Vulnerabilities in client confidentiality

Findings

The firm was recycling paper by loading its printers and photocopiers with stale-dated intra-office documents, so the reverse side of the pages could be used. There were no controls to ensure that confidential client information, which could appear on the original document, was not thereby circulated within the firm, or indeed to clients or other persons outside the firm.

Basis for action under the current legislation

Commission staff found that:

- The firm violated section 14 of the Rules, which requires firms to deal fairly, honestly and in good faith with its clients, because this practice could result in breaches of client confidentiality.

- The firm violated section 44 of the Rules, which requires firms to establish and apply written prudent business procedures. The firm's practice of using recycled documents in its printers could result in confidential client information being inadvertently disclosed to recipients of printed documents, be they other clients or firm employees.

- The firm violated section 3.2 of National Instrument 33-102 *Regulation of Certain Registrant Activities*, which requires clients to consent to the release of confidential information by the firm or its employees.

Basis for action under the BC Model

Commission staff found that under the BC Model the firm would have violated Principle 3 of the Code, which requires firms to hold in strict confidence all confidential information acquired in the course of their relationship with clients.

Conclusions

Commission staff found that the BC Model would deal with this issue just as effectively as the current legislation.

3. Enforcement Under the BC Model

The firms we interviewed had two concerns relating to enforcement. The first was the risk of being judged in hindsight, as discussed earlier (see *Audit Practice under the BC Model*). The second was whether enforcement under the BC Model would be effective at removing "bad apples" from the market. A third related risk (not raised by the four firms but that we have heard from others) is that under an outcomes-based regime, the Commission could use enforcement proceedings to declare a long-standing industry practice as not compliant with the Code. We will discuss this risk first.

Making Regulation Through the Hearing Process

The risk of the Commission essentially making new rules of general application through its decisions and settlements has to be considered in the context of the Commission's regulatory development process. There are three aspects to consider. First, the Commission's practice for some time, and particularly in developing the BC Model itself, has been to consult extensively with stakeholders before adopting major regulatory initiatives. This is to ensure that before imposing new requirements or standards, the Commission is fully aware of the implications, which reduces the risk of unintended consequences.

Second, as the Commission moves to a regime in which guidance to industry plays an increasingly significant role, the Commission will adopt a similar approach to developing guidance on major issues, especially when that guidance may change how business has traditionally been done.

Third, industry education and guidance will be a central feature of the Commission's administration of the BC Model. When new rules or interpretations are adopted, the Commission will be pro-active about informing industry of the changes, and will give industry a reasonable period of time to adjust to the changes. For example, when the BC Model is introduced, the Commission will educate industry about it, paying particular attention to those areas of the Code that could require changes in current practice. Industry will then have a period of time to alter its procedures as necessary to comply with the Code and the other new rules.

Using the enforcement process to impose new rules on industry overnight is inconsistent with this approach. If, as a result of revelations arising from a hearing or an investigation, the Commission were to determine that a widely-accepted industry practice required review, it would put the matter on its list for regulatory development initiatives and deal with it through the process described in the previous paragraphs.

The risk is therefore remote that major changes to industry practice will be imposed overnight through Commission decisions or settlements.

Effective Enforcement Under the Code

The four firms asked a question that has been asked by others who have commented on the BC Model: Can it be enforced as effectively as the current legislation?

To answer this question, we did two things. First, we compared the provisions most commonly relied upon to enforce the current legislation to the corresponding provisions in the BC Model. Second, we considered what enforcement challenges would be presented by other provisions in the BC Model.

Before presenting the results of this analysis, it is worth reiterating that the BC Model, although an outcomes-based regime, consists of rules. The Code of Conduct, for

example, is a set of 28 rules organized under eight principles. As rules, they would have the force of law, and therefore be enforceable as legal obligations.[41]

1. What is enforced today? What will be enforced under the BC Model?

Between January 1, 2002 and November 14, 2003, the Commission rendered two decisions and entered into 15 settlements relating to registrant misconduct. The 66 contraventions of the current legislation in those decisions and settlements are broken down as follows:

Know your client and suitability[42]	15
Fair dealing with clients[43]	13
Supervision[44]	9
Illegal distributions[45]	8
Prudent business practices[46]	7
Misrepresentation[47]	6
Other[48]	8

This distribution of contraventions is reason for confidence that enforcement under the BC Model would be no less effective than under the current legislation, for these reasons:

- 45 of the 66 contraventions (68%) in these cases were in the areas of know your client and suitability, fair dealing, prudent business practices, misrepresentation, and fraud.[49] In these areas, the language in the BC Model is substantially similar (sometimes nearly identical) to that used in the current legislation. It is therefore reasonable to conclude that the enforcement results under the BC Model in these areas will be the same.

- Another 11 of the 66 contraventions (17%) were in the areas of illegal distributions and trading and advising without registration.[50] Although the structure of the BC Model differs in these areas, it has corresponding prohibitions against trading or advising without being registered and against issuing securities without complying

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[41] Enforcement in this context means administrative, not criminal enforcement. The Code of Conduct is not among the provisions in the BC Model that carry criminal liability (nor are almost all of the provisions of the current legislation that the Code replaces). Civil enforcement will be the subject of a future paper on the Investor Remedies proposals in the BC Model.

[42] Rules, section 48

[43] Rules, section 14

[44] Rules, section 47

[45] Act, section 61

[46] Rules, section 44

[47] Act, section 50

[48] Registration – 3 (Act, section 34)
Information about registrant – 2 (Rules, section 50)
Record keeping by registrant – 1 (Rules, section 27)
Safekeeping of client funds – 1 (Rules, section 58)
Fraud – 1 (Act, sections 57, 57.1)

[49] In many of the cases, there were multiple contraventions of one provision, which were counted only once for the purpose of this analysis. Had the multiple contraventions been counted separately, the results would have been even more heavily weighted in these areas.

[50] All of these cases involved registered dealers, but the registration requirements were still contravened. For example, one firm registered elsewhere in Canada, but not in British Columbia, was trading for and advising clients in British Columbia. Another dealer was permitting non-registered employees to engage in registrable activities.

with a mandated disclosure regime. There would therefore be grounds for enforcement action in the BC Model against registrants (or others, for that matter) who trade or advise without being registered, or sell securities without following disclosure requirements.[51]

- The remaining 10 contraventions (15% of the 66) were in the areas of supervision, informing clients, record-keeping, and safekeeping of funds. In all of these areas, there are provisions in the BC Model that replace or correspond to the relevant provisions in the current legislation.[52] As discussed in section 2 below, it is reasonable to believe that these new provisions will be as capable of ready enforcement as today's rules, and in some instances, more so.

Commission sanctions are not always based on contraventions of the Act and the Rules. In some cases, the Commission also makes orders based on its general power in section 161 of the Act to make orders in the public interest.[53] *Re Cartaway*[54] is instructive as an example of how conduct now handled in enforcement proceedings under the general public interest power could be handled under the BC Model.

In *Cartaway*, the Commission found that the respondents contravened various sections of the Act and Rules. However, much of the conduct that contributed significantly to the sanctions imposed by the Commission was conduct that did not contravene any specific provisions of the Act or the Rules, but was found by the Commission to be contrary to the public interest.

Background

The respondents were among a group of eight brokers employed by a registered dealer and who bought control of Cartaway Resources Corporation, a shell company listed on the Alberta Stock Exchange.[55]

The brokers intended to change Cartaway's business direction and finance it through their dealer. To this end, the respondents acquired a group of Voisey's Bay claims for Cartaway through a nominee private company. At the time, the Voisey's Bay area of Labrador was experiencing a major staking rush as a result of a significant mineral discovery.

Meanwhile, Cartaway completed a brokered private placement 80% of which was bought by the eight brokers. As a result, they were in the money by a factor of three and owned over 70% of Cartaway on a fully diluted basis. Cartaway announced the private placement but did not disclose the acquisition of the Voisey's Bay claims.

A couple of months later, Cartaway closed another brokered private placement. The brokers' dealer was agent for the offering and all of it was placed with the dealer's clients. In announcing this financing, Cartaway disclosed the acquisition of the Voisey's

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[51] See BC Model, *Draft Legislation*, Act, sections 3A1, 4A1.

[52] See Code of Conduct, Principle 7, sections 1-3 (supervision), Principle 2, sections 1 and 2 (informing clients), Principle 2, section 3 , BC Model, *Draft Legislation*, Rules, sections 3D3, 10A1 (record keeping), and Principle 7, section 7 (safekeeping).

[53] This power is kept in the BC Model.

[54] 2000 BCSECCOM 88. The Commission imposed sanctions in *Re Cartaway* 2001 BCSECCOM 594.

[55] A predecessor of the TSX Venture Exchange.

Bay claims for the first time. It did not disclose the roles of the respondents in acquiring the claims, the extent of the shareholdings of the eight brokers, or any of the related conflicts of interest.

Commission findings

The Commission found that the respondents had contravened disclosure requirements, the prohibition against selling securities without filing a prospectus (the panel found that an exemption purportedly relied upon was not available), and the duty to act fairly, honestly and in good faith with their clients.

More germane to this discussion, the panel also found that the respondents had acted contrary to the public interest because they:

- put themselves in a position in which their interests were in conflict with their duties to their clients, and then acted in their own interests and not in the best interests of their clients
- failed in their duty to act as gatekeepers of the securities markets and not to engage in any conduct that would tend to bring the reputation of the securities markets into disrepute
- deceived and intentionally misled their dealer, its clients, the exchange and the public
- failed, as the de facto directors and officers of Cartaway, to act honestly, fairly and in the best interests of Cartaway

The current legislation contains no provisions that deal directly with this conduct.

How the "public interest" findings could be handled under the BC Model

The Code deals directly with the types of conflict of interest that were found in Cartaway. The Code requires registered firms and their representatives to resolve all conflicts of interest in favour of the client using fair, objective, and transparent criteria. It also requires disclosure to the client of any information that a reasonable client would consider important in the ability of the firm or its representatives to provide objective service or advice.[56] As noted in the guidance, it makes it clear that the clients' interests always come first. The guidance highlights the risk of conflict that arises when representatives of registered firms act as directors of issuers. The conduct of the respondents in *Cartaway* would have been demonstrably in contravention of these provisions of the Code on the basis of the facts found by the panel.

The Code also states that registered firms and their representatives must not engage in conduct that would bring the reputation of the securities market into disrepute.[57] The guidance refers to the gatekeeper role. The conduct of the respondents in *Cartaway*, as found by the panel, would have contravened this section of the Code.

[56] See Code, Principle 6, sections 1, 3.
[57] See Code, Principle 1, section 4.

The Code requires that registered firms and their representatives act honestly, fairly, in good faith and in the best interests of their clients.[58] The deceit and misleading statements found by the panel in *Cartaway* would clearly violate this provision, as well as the duty not to bring the reputation of the securities market into disrepute.

The BC Model imposes duties on directors and officers of issuers to act honestly and in good faith with a view to the best interests of the issuer, and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.[59] The conduct of the respondents in *Cartaway*, as found by the panel, would have contravened this provision.

These examples show how the Code would deal more clearly with conduct that the Commission found to be contrary to the public interest.

2. Proving allegations of misconduct in other areas under the BC Model

In the previous section we saw that the principles-based rules in the current legislation form the foundation for most enforcement action against registrants, and that these rules are carried forward in substantially similar form in the BC Model. We also saw that the BC Model provides a more specific basis to take enforcement action against some forms of conduct that is currently dealt with solely though the Commission's public interest jurisdiction.

This accounts for six[60] of the 43 rules in the Code and Divisions D and E of the Part 3 of the Rules under the BC Model, which regulate the ongoing conduct of dealers and advisers. That leaves 37.

Many of the rules in the BC Model, including several provisions of the Code of Conduct, express regulatory requirements in terms of observable outcomes – for example, requirements to segregate client assets or to create a "Chinese wall". Of the remaining 37 rules, 24 fall primarily into this category.[61] These requirements pose few enforcement challenges out of the ordinary – generally it will be clear on the evidence as to whether or not the respondent delivered the outcome mandated by the Model. That leaves 13.

Another nine rules[62] either contain objective legal tests, or deal with areas about which there is already a high level of understanding about what conduct is expected. An example of the former is section 1 of Principle 2, which imposes the requirement to keep clients informed of all facts "that a reasonable person would consider important to the business relationship". Although this is not a bright line test, courts and tribunals are accustomed to dealing with standards expressed on the basis of reasonableness, and the evidentiary requirements necessary to establish compliance or non-compliance with those standards.

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[58] See Code, Principle 1, section 1.

[59] BC Model, *Draft Legislation*, Act, section 10A1.

[60] Code: Principle 1, sections 1, 2, 4; Principle 5, sections 1-3.

[61] BC Model, *Draft Legislation*, Rules: Part 3, Divisions D and E; Code: Principle 1, sections 3, 5, 6; Principles 3, 4; Principle 6, section 2; and Principle 7, sections 4, 5, 7.

[62] Code: Principle 2, sections 1-3; Principle 6, sections 3, 4; Principle 7, sections 1, 2, 3, 6.

An example of the latter is section 3 of Principle 7, which imposes the requirement to hire only suitable individuals and to supervise them. As noted earlier in this paper, the important principles of supervision are well-understood by industry participants.

We therefore do not think that these requirements will pose significant enforcement challenges.

This leaves four rules: Principle 2, section 4 (plain language), two sections in Principle 6 (Conflict of Interest)[63] and Principle 8 (Client Complaints). All of these rules reflect broader regulatory principles and some are new in concept. For that reason, some uncertainty is to be expected after implementation of the BC Model until market participants, regulators and courts gain experience in interpreting and applying the new rules.

The rule likely to be of most interest from an enforcement perspective is section 1 of Principle 6, which states:

> Resolve all significant conflicts of interest in favour of the client using fair, objective, and transparent criteria. If there is a conflict of interest between clients, use fair, objective and transparent criteria to resolve those conflicts. In both cases, apply the criteria consistently.

The concern of enforcement staff would be that what constitutes "fair, objective and transparent criteria" may well lie in the eye of the beholder and it could be difficult to prove a violation of this standard.

There is a risk that some might try to exploit this language by palming off an inadequate set of criteria as "good enough". However, this scenario must be considered in context. The vast majority of the regulated community is compliance-minded and will use the period following implementation of the Code to develop criteria and policies that meet the spirit and intent of the Code, as described in the guidance published at the outset and as developed over time. Through this mechanism, industry will develop a standard that is considered effective in delivering the outcome required by this rule.

Although not determinative, evidence of industry practice is a relevant benchmark in measuring impugned conduct. This is so today, and will be so under the BC Model. The firm whose standards are significantly lower than those generally followed by its peers would have to justify the differences. This is especially so if the firm has systemic flaws that have either actually harmed clients, or have exposed them to significant risk of harm, which is likely to be alleged if the matter is being dealt with through enforcement proceedings.

We think it is reasonable to conclude that the development of standards by industry in response to the Code, and the continuing updating of guidance by the Commission in response to industry questions and concerns, will deliver a standard of certainty sufficient to deal with misconduct at the level at which enforcement proceedings are appropriate. Further certainty would emanate from Commission decisions in enforcement matters.

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[63] Sections 1, 5.

Firms that are intentionally non-compliant are on even riskier ground. The Code forces firms to take responsibility for compliance and the intentional violator is exposed to administrative sanction under a host of Code provisions.

Conclusions

We have seen that:

- The most significant enforcement action taken under the current legislation will continue to be supported by corresponding provisions in the BC Model.

- For some types of conduct, the BC Model provides a more specific basis for enforcement action than the current legislation.

- Most of the rules in the BC Model will be readily enforceable because they require measurable outcomes, use objective tests that are familiar to adjudicators, or deal with areas in which there is a rich understanding of what constitutes acceptable and non-acceptable conduct.

- The new rules in the BC Model will be enforceable based on the development of industry standards, assisted by jurisprudence on the new rules.

We therefore think it is reasonable to conclude that the BC Model would provide a solid foundation to take enforcement action against market misconduct – as least as solid as today's, and more so in some important areas.

IV. Costs and Efficiencies

The four firms who participated in the study commented that a move from the current legislation to the BC Model carried cost implications, both positive and negative, but they were unable to quantify them specifically and extensively enough for us to define the costs in specific dollar terms.

However, in our interviews with the firms we identified sources of cost increases and decreases. Based on these and other findings, and the economic arguments below, we believe we have identified the most significant cost impacts, both positive and negative, associated with the implementation of the BC Model as it relates to the regulation of dealers and advisers.

We believe there would be efficiencies in moving to the BC Model regardless of firm size. Although there are some areas in which compliance costs could increase under the BC Model, we believe these are more than offset by likely decreases in other areas. Overall, we expect the transition to the BC Model to be, at worst, cost-neutral.

General Finding

In our discussions with the four firms about the cost issues they face under the current system compared to the BC Model, we found that any given rule frequently affects large and small firms differently.

Large firms have much larger networks, which makes it difficult for them to monitor compliance manually. They have large spans of control, thousands of accounts and hundreds or even thousands of representatives. Any rules that mandate manual reviews are therefore disproportionately burdensome on large firms. Generally, large firms also have more conflicts than smaller firms. They are usually in more types of businesses, manage large house accounts, and have "Chinese walls" that need to be properly run.

On the plus side, large firms have more information technology resources to develop and administer the automated systems they need to track compliance issues. Rules that mandate sophisticated systems (such as ownership tracking or statistical sampling) can be easier for larger firms (although, as demonstrated by the effects of the new analyst conflict rules, significant costs can still be experienced). A large firm also enjoys lower unit costs for legal advice on new rules and because of the thousands of trades it executes each day, quickly gains experience that it can use to modify policies.

Small firms can make better use of manual systems for non-compliance detection and avoidance, and usually have fewer areas of conflict to deal with in the first place. Rules that mandate manual processes are therefore less of a problem for them. However, rules that imply a systems solution are difficult and costly for them to implement. The requirement to track security holdings in the new analyst conflict rule is a good example. Each firm needs a complex and expensive system to prove the firm does not have a significant ownership position in the issuers it covers, even though the likelihood of a conflict for this reason is remote for many small firms, especially those with no house account.

Small firms may also have fewer resources to put towards writing guidance and developing new policies, and when they need to hire outside legal advice, their unit costs are higher than larger firms experience.

Therefore, rules that mandate processes universally across industry are likely to have a disproportionate impact on firms, depending on their size and operating characteristics. This is shown by the findings in the section on account supervision. Firms told us how they would likely respond in a Code-based environment: the larger firms would use more technology, more random spot checks, more exception reporting, and pattern finding. Smaller firms would involve more people and more manual processes. This is, of course, what the BC Model is intended to do – set the desired outcomes and then allow each firm to choose a means of compliance and oversight that makes the most sense for its structure.

A. Transition Costs

1. Training

The firms believed that the training associated with the roll-out of the BC Model could be handled within their existing training vehicles with little incremental cost. This has to do with the low-cost nature of internal training tools and is informed by their recent experience in training their workforce about money laundering requirements.

Training for existing employees at the largest firm happens four ways:

- Conference calls, used when there is a broad issue to be addressed and the discussion needs to be interactive. (This is used sparingly - there are 100 branches and thousands of investment advisers to cover. At 15 or so people per call this can be a very time-consuming process.)
- Compliance bulletins, which go out electronically and in hard copy. These can introduce major new initiatives such as the BC Model.
- Meetings held during branch compliance audits. While on site, the compliance officers from head office will hold one to three meetings per branch on key compliance issues. The presentations review key things nationally and are also tailored to the issues of that branch. This is a good way to train without incurring major additional costs, though the roll out is slow.
- Regional conferences for sales representatives and branch managers. Compliance officers will fly in and do a few hours of training at such events. These, in conjunction with compliance bulletins, are a good way to change practices across a large group of people.

None of these approaches requires significant cost outlays. This firm's experience in training its representatives about money laundering confirms that these low-cost methods met its needs. They spent a few days in compliance time to prepare three extensive bulletins. Compliance officers also spent about a day of work to develop a 16-page money laundering training module for branch audit presentations. Given the size of the organization and the significance of the change, this training cost is modest.

The largest out-of-pocket cost we were able to uncover by talking to firms about training costs for the new money laundering rules was $15,000 paid by one firm to develop a

binder explaining the money laundering legislation and to create a webcast, which employees can download from the firm's intranet and earn continuing education credits.

A large part of the training for money laundering came with process changes. Training occurs as firms make changes to their procedures. The same would happen for changes associated with the BC Model. Firms will make procedural changes either to implement efficiencies enabled by the BC Model's flexibility, or to live up to the higher standards of investor protection in the Code. No firm saw this training as adding significant expense.

2. Firm policy setting

One of the top concerns for the firms is whether, under the BC Model, they would have to reconstruct their policies from the ground up. It appears they would not.

The compliance function in firms monitors many areas, as is evident from our review of the four firms' compliance manuals. In working with each dealer, we familiarized ourselves with its compliance manuals cover to cover. We found that much of what is covered by the firms' compliance manuals relate to areas that would not be affected if the Code were implemented (even assuming it replaced corresponding IDA requirements), for example:

- Capital requirements[64]
- Cash and securities loan transactions
- Client and financial accounting
- Corporate Finance procedures
- Insider reporting
- Insurance requirements
- Money laundering requirements
- Prospectus handling
- RRSPs
- Settlement procedures
- Shareholder communications requirements
- Trading procedures
- US IRS requirements

In fact, the percentage of the four firms' compliance manuals that is devoted to matters not affected by the Code ranged from a low of 42% to a high of 71%.[65] The firms also told us that matters like money laundering rules, IRS compliance policy, privacy and capital adequacy consume a lot of compliance time, so the proportion of compliance

[64] No changes to capital requirements are contemplated for IDA members under the BC Model.

[65] Pages of compliance procedures not relating to Code of Conduct areas:

Dealer	Percent of compliance manual not relating to the Code
Firm A	42%
Firm B	71%
Firm C	46%
Firm D	65%

resources spent on non-BC Model items might be even higher than indicated by the page count of the manuals.

Therefore, much of the firms' compliance manuals will not be affected by a move to the BC Model. Although firms would have to review their manuals to ensure that they reflect the outcomes in the Code in the areas of conflict of interest and dealings with clients, the BC Model will not affect many areas that the firms told us are major consumers of compliance resources.

In the areas we studied, we also saw that the firms' procedures as carried out today would likely comply with the requirements of the BC Model, and we think this will generally be the case in most areas. There are some areas under the Code that may require firms to re-examine current policy (for example, the disclosure requirements under Principle 2, and some aspects of handling conflicts of interest under Principle 6). But the main issue in the transition will be which areas the firms wish to reassess, and over what time frame, to take advantage of the procedural flexibility available under the BC Model.

For these reasons, we conclude that transition costs in this area would not be significant.

3. Systems costs

The firms did not foresee any systems cost implications arising from a transition to the BC Model, other than costs they may choose to incur to take advantage of the procedural flexibility offered by the BC Model (and thus recapture those costs and earn a return on them).

The larger firms are already using technology extensively in the systems they have built in parallel to the mandated review processes. Smaller firms would continue to rely more on manual systems.

B. Ongoing Costs

1. Cost Factors

Through our discussions with the firms, we identified three major factors that would influence ongoing costs under the BC Model compared to today:

Factor 1 – The BC Model allows more procedural flexibility

In the previous sections of this paper we cited several illustrations of the procedural flexibility that the Code would allow. We also noted that the parallel compliance systems the firms have built under the current regime would deliver the outcomes contemplated by the Code, and that, in a Code-based environment, the money they are currently spending on mandated transactional reviews could be redeployed to more productive compliance uses.

Under the Code, firms would have the freedom to replace the most labour-intensive areas of their compliance processes with risk-based monitoring. In effect, this allows firms to get much closer to the minimum necessary cost of supervision. Current rules rarely create this optimization.

Factor 2 – Frequency and complexity of rule changes

We expect the frequency of new regulation to be lower under the BC Model than the system today. When rule changes do occur, they are likely to be simpler and more outcomes-based under the BC Model.

The firms told us that they spend significant resources reading, interpreting and applying new detailed rules. As mentioned in the findings, one firm spent nearly 18 person-months of senior professional time in preparing a policy in response to NASD Rule 2711 and IDA Policy 11.

However, that firm said that if it had only to comply with the Code, the effort would have been greatly simplified. Why? Because most of its effort was put into figuring out how to fit the prescriptive rules into the reality of running its business. Rules around e-mail communication, simultaneous distribution, and disclosure in public comments took time to sort out not because the new rule was vague, but because complying with the letter of the rule forced the firms to make significant changes to its policies even when the firm saw more reasonable ways to deal with a given conflict.

This type of policy-making trickle-down is present every time a firm faces new rules. And we issue new rules under our current system frequently. In the past five years in British Columbia, many new instruments have been introduced that deal exclusively with registrants. Twenty-three of these are still in force.

Under the Code, the frequency of rule-making should drop significantly – the Code is written to require the key outcomes expected for clients and markets – outcomes that have changed little over the years. Instead of having to write new rules to cover every new variant of misbehaviour, we expect that we will be able to conclude that the Code already covers the activity. That would give us the option of dealing with the situation through compliance reviews, enforcement action, new guidance, or a combination of all three.

Where industry practice is already in line with the Code, firms would be free to make changes that help simplify their system while delivering Code outcomes. Initiatives to do so may consume time, but would deliver a streamlined process. The Code gives firms the option to undertake these projects, but they are not mandatory. Where current industry practice may not be in compliance with the Code, the Commission will give industry reasonable time to develop acceptable practices to deliver the outcomes mandated by the Code and will provide guidance as appropriate.

For example, in considering analyst conflicts we saw that, even if the Commission were to create a rule to raise industry standards, compliance departments and organizations need to spend a lot of time implementing a rule. Under the Code, fewer specific things are mandated, allowing firms to find the solutions that create minimum disturbance to their key business processes.

To test this idea further, we looked at the 23 current instruments relating to registrants introduced over the past five years. The BC Model covers the content of 16 of them without the need for the rule itself, and the remaining seven are simply eliminated and not replaced under the BC Model.[66] This means that, had the BC Model been in place five years ago, none of these 23 instruments would have been necessary. The fact that the BC Model would have forestalled all these instruments is a strong indicator that, under the Model, firms would spend significantly less time adapting to rule changes.

Factor 3 – Audit practice

The BC Model is more focused than the current system on outcomes and less on rote compliance with mandated procedures. The impact this has on audit practice was discussed earlier.

Our study uncovered ways that the audit process adds complexity to the compliance process without improving it. By revisiting how commissions and SROs audit for sales compliance, we can both refocus the audit on the compliance system and address problems with the audit process.[67]

2. Applying the Factors

Training costs

Firms did not see that ongoing training costs would change much.

Training for new employees at the largest firm includes three hours of initial compliance training. New investment advisers are also required to read all the manuals. Under the BC Model, this would work the same way it does today. At the other large dealer, new employee training is self-study (only five of the 400 pages of materials deal with compliance). It also requires trainees to complete the CSI course that covers the Conduct and Practices Handbook, and we would expect the Code to be explained there. Training costs are also likely to be limited for the reasons described under Cost Factor 2 – with fewer rule changes, and simpler rules when they do change, we expect training costs to be no higher than under the current system. Many rule changes are reflected in new workflows. As the workflows change, the employee gets trained in the new rule. None of the firms was concerned that this would be a significant cost issue.

Firm policy-setting

This cost area is affected by Cost Factor 2. With fewer and simpler rule changes, policy reviews will arise less often, and will take less time, than under the current system. The firms noted that setting firm policy takes the time of senior compliance staff, but many reviews they would undertake as a result of the Code would be aimed at making the system more efficient.

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[66] Six of the seven deal with registration issues that are not relevant under the firm-only registration regime in the BC Model. The sixth deals with shares of cooperatives. Under the BC Model, membership shares are not "securities" but investment shares are and are treated the same as other securities.

[67] See Section III. C.

New firms joining the market today need to submit a policies and procedures manual to regulators. One concern we heard was that new firms would have to invent the compliance process from the ground up, creating a barrier to entry.

Getting a policies and procedures manual in place is a hurdle for any new firm. Almost all of the firms seeking new registration since October 2001 had to revise some part of their manual to meet Commission standards.[68] Most new firms outsource the writing of their compliance manuals. We expect that those in the business of writing these manuals will help firms comply with the Code just as they help them comply with the Rules today.

Under the BC Model, firms needing to revise their manuals would continue to receive the guidance the Commission provides today on necessary improvements. Much of today's standard practice in key areas would be acceptable under the BC Model, so it is unlikely that new firms would find the process of securing approval for their manuals more burdensome than it is today.

Ongoing compliance costs

All of the cost factors suggest that ongoing compliance costs should not rise, and in fact are more likely to fall, under the BC Model.

At one of the large firms, half of their 30 compliance people spend about half their time on daily and monthly reviews and the other half on other account and representative supervision tasks. At the other large firm, nine of its 16 compliance staff work in daily and monthly reviews. As discussed above under *Account Supervision*, day-to-day work of supervision will change significantly under the Code for these firms and represent gains for them. As noted, however, they did not expect to eliminate compliance resources as a result, but to deploy them more effectively.[69] However, with more control over these costs, firms may well find more efficiencies than they see today. In any event, costs in this area are unlikely to rise.

As a way of getting an idea of the potential for efficiency gains, we looked at line item detail for account supervision and marketing procedures at three of the four firms we interviewed.[70] We identified the source of each requirement in the firms' policy manuals: BC legislation and rules, IDA requirements, other regulatory bodies, or that firm's view of good business practice. We found that, of the 469 requirements we reviewed across the three firms, only 40, or 9%, were directly influenced by securities rules. The IDA rules played a much more prominent part of the manuals, with 259 requirements or 55% of the total (See Table 1 of Appendix 4).

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[68] During this period the BCSC registered 16 new firms with head offices in British Columbia and no relationship with an existing registrant.

[69] One firm emphasized that creating a more varied and investigative style to account supervision will help them improve the productivity and retention of existing staff.

[70] The smallest firm's statistics were not used in this analysis because its compliance manual contained a minimal amount of unique content on these two areas, in part because their CEO handles all marketing issues and in part because it has only a handful of representatives to supervise. The analysis also omits areas relating to IDA Policy 11 *Analyst Standards* for all firms because at the time of our review the firms' policies in this area were only in draft form.

We asked each firm which of the requirements in their policies and procedures manual they would change if the BC Model were implemented. Commission staff also reviewed the same requirements and made the same assessment. These are the results across the three firms:

	Keep as is	Revise or eliminate
Firm view	60%	40%
Commission staff view	19%	81%

So the firms that have spent time with us understanding the Code would still keep 60% of the requirements (responses from the three firms ranged from 44% to 69%). However, Commission staff believes that under the Code these firms could eliminate all but 19% of the requirements in their manuals (the range based on each firm's manual went from a low of 13% to a high of 22%). Examples of areas where firms would keep current rules that we think they could delete illustrate the difference between firms' and the Commission's views of the flexibility allowed by the Code.[71] We attribute the discrepancy between what the firms say they would do and what we think they could do to two factors.

First, the firms are being naturally conservative in thinking about how to take advantage of the BC Model until they have actual operating experience with it. We believe that, once firms gain that experience, they will take increasing advantage of the flexibility the Code offers and build more efficient compliance systems than they can anticipate today.

Second, although the Commission may believe the rules are not necessary to produce the desired regulatory outcomes, firms may well conclude, for their own reasons, that they should keep many of the current rules. However, in that case, the requirements that burden those firms will be founded on their own perceived needs, not regulatory decree.

Finally, the Code could generate costs over and above today's system if firms find Commission guidance deficient and incur expense soliciting more guidance, either from the Commission or their own counsel. However, one of the core design goals of the BC Model is to enable market participants to handle routine compliance matters without having to retain expensive professional advice. The Commission will consult with market participants as it designs and maintains its guidance vehicles to ensure that this goal is met.

Systems costs

We found no areas in which the BC Model would require new systems, but it appears that it could lower ongoing development costs by allowing a wider variety of procedural options. The central benefit of the BC Model for systems costs is that a firm can address an area of investor protection in many different ways even when systems are involved. Instead of having to accommodate a specific, mandated process (for example, obtaining manual signatures), the firm can use Code principles when evaluating various technology options that produce the desired outcome.

[71] These can be found in Appendix 4.

Factors 2 and 3 (the flexibility of options in how firms can comply with the Code and the stability of the Code's platform over time) suggest lower systems costs under the BC Model (or, for larger firms, systems costs with better paybacks). As we have seen, the larger firms in our sample are enjoying some efficiencies from the improvements, supplements, and replacements (many systems-based), that they have implemented to run in parallel with the mandated procedures under regulation. Under the Code the efficiencies they now enjoy would be increased because they could stop doing the less efficient reviews currently required.

The current system, which tends to impose specific rules, carries a greater risk than the Code of requiring systems for regulatory reasons regardless of the actual benefits for investor protection. The Code facilitates a better balancing of the costs of developing new systems against the investor benefits that those systems will yield.

The systems implications of IDA Policy 11 are an example. All firms commented on how expensive it will be to build an information system to comply with the new disclosure requirements. Looking at this issue from a Code perspective, if the firm needed to track share holdings, it could go back to the fundamental conflict of shareholdings and design a process that would disclose some firm-determined threshold relative to the holding that create the conflicts. Ways to pare down the information technology burden could include:

- replacing real time processes with monthly processes, unless a single transaction exceeded a specified percentage of the share class
- collecting and disclosing only whether the firm beneficially owns any shares of an issuer (without determining the exact number)
- collecting information from affiliates only about share classes that are already widely held in the dealer firm
- opting out of any specific share disclosure if there is no house account and addressing the potential conflict of share holdings by other connected parties, using more general language

In general, the Code allows firms to invest in technology when it is an efficient solution to a potential compliance issue and to use more manual processes when technology is not efficient. Using technology as a tool to comply more efficiently with a regulatory requirement is left in the hands of the firms under the Code. For many larger firms, this route will be attractive. Smaller firms will be more likely to create reasonable processes that deliver the BC Model outcomes without incurring the technology development expense.

Administrative Litigation

The U.S. Securities and Exchange Commission (SEC), studying a principles-based accounting system, addressed administrative litigation in a paper earlier this year.[72] The paper noted that the increased reliance on the judgment of industry professionals that is inherent in a principles-based system may increase the likelihood of retrospective

[72] Office of the Chief Accountant, Office of Economic Analysis, "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System."

disagreements on compliance procedures. This line of reasoning leads to the hypothesis that regulatory litigation could increase.[73]

The SEC concluded that objectives-oriented standards better align the incentives of firms and shareholders, and so there should be an overall reduction in litigation. The paper says that if firms maintain documentation demonstrating that they thought responsibly about their policy approach, their exposure to litigation may be relatively minimal.

We agree. We think the risk of increased regulatory litigation attributable solely to the implementation of the BC Model is remote, for these reasons:

- Many rules in the BC Model have clear boundaries. Many others simply carry forward other long-standing principles-based rules, such as know your client, and the prohibitions against fraud and misrepresentation.

- Most of the Code will be complied with if firms merely continue familiar and widely-used practices. As they gain confidence with the flexibility offered by the Code, firms can make incremental changes to their procedures to minimize risk.

- Where changes to their procedures are required as a result of the Code, firms will have the benefit of Commission guidance in developing their new procedures, and can reduce risk by documenting how they turned their minds to the outcomes expected by the Code, and the processes necessary to deliver them.

Civil Litigation and Insurance Costs

The new investor remedies proposed under the BC Model could have cost implications. We are conducting a separate study of these potential costs.

[73] The hypothesis described in the paper included civil litigation as well. This will be covered in a future BCSC paper on the BC Model's Investor Remedies proposals.

Conclusion

We undertook this study to answer three questions:

1. Would the BC Model protect investors as well as the current system?

We have concluded that the BC Model would protect investors as well as, and in some instances, better than, the current regime. We saw that:

- In addition to retaining core elements of current regulation, such as the fairness and honesty standard, know your client, and suitability, the Code also includes new investor protection elements such as dealing with client conflicts and customer complaints.
- In the areas of account supervision, marketing oversight, and analyst conflicts, the BC Model's emphasis on outcomes, rather than procedures, would help keep the compliance focus, at both the firm and the regulator level, aligned with the interests of investors and the market. The Code focuses firms on what is material, whereas traditional rules mandate specific behaviors regardless of their effectiveness in addressing an area of compliance risk.
- The firms in our study would take advantage of the flexibility offered by the BC Model in designing procedures by re-allocating resources to more effective means of preventing and detecting misconduct.
- Because the outcomes mandated by the BC Model are more timeless than many of the rules they replace, the Model would be more adaptable to changes in the regulated environment. This means that new compliance and enforcement challenges can be dealt with earlier using the tools at hand, compared to more rules-based regimes that need to create a new rule for each new problem.
- The BC Model would be a better basis than the current regime for conducting compliance reviews of dealers and managers with a view to ensuring that their policies and practices were effective in protecting investors and markets.
- The BC Model forms a stronger foundation for effective enforcement than the current regime.

2. Would dealers and advisers know what to do, and behave as expected, under the BC Model?

From the responses of the four firms who participated in our study, it is reasonable to conclude that firms would understand what is expected of them under the Code of Conduct, and would meet those expectations. We saw that:

- Firms naturally gravitate to outcomes-based approaches. They already design their compliance systems to deliver outcomes – outcomes that are consistent with those in the BC Model. What they told us about how they would respond to regulation under the BC Model demonstrates that they understand what it expects.
- Firms are motivated, even in the absence of regulation, to have effective supervision systems, and will devote significant time and resources, both initially and ongoing, to ensure that they do. The four firms in our study would be virtually in compliance with the Code using their existing practices, so we are confident that they would meet the expectations imposed on them under the BC Model.

- When new compliance and enforcement challenges arise, firms will learn the key compliance concerns through the guidance process and adopt a new level of industry practice without new rules.
- All but four of the rules in the BC Model have clear deliverables, or rely on tests that are broadly understood. The initial uncertainty associated with the remaining four rules will be resolved primarily through the development of industry standards and Commission guidance.

3. Would the BC Model impose significant transition or new ongoing costs to dealers and advisers?

We saw that a transition to the BC Model was not likely to trigger significant transition or ongoing costs. We also saw that, although we did not quantify them, there is some potential for cost savings in the long term:

- Operating under the BC Model would give the firms numerous opportunities to capture efficiencies in their compliance function, efficiencies they say would translate into better prevention and detection of misconduct.
- The audit approach under the BC Model would avoid the inefficiencies that result from current audit practice.
- The BC Model uses simpler rules that need changing less frequently, so the costs responding to new rules, including systems and policy development costs, is likely to be lower than under the current regime.

The cost analysis shows that there are no significant new costs associated with a move to the Code. Although there appear to be opportunities for future cost savings, their significance cannot be measured until firms actually operate under the Code. Therefore, the main factors to consider are how well investors will be protected and how efficient it would be for firms to operate under the BC Model. This study shows, that compared to the current regime, the BC Model would provide stronger protection for investors and more efficiency for firms.

Appendix 1 – The Code, Guidance and Ongoing Conduct Rules

Code of conduct

A registered dealer or registered adviser must comply with the following Code. Each representative of a registered dealer or registered adviser must comply with the following Code, except Principle 7.

In this section, the provisions of the Code that are found in the Rules are in bold face type. The relevant guidelines appear underneath in ordinary type.

Principle 1 — Integrity and fairness

1. **Act fairly, honestly, and in good faith and in the best interests of your client.**

2. **Exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.**

You have a duty to your clients to act fairly, honestly, in good faith and in their best interests. Examples of conduct that would violate this duty are:

- Front running
- Wash trading
- High closing
- Account churning
- Pricing illiquid securities artificially
- Delaying client asset or account transfers
- Failing to provide "best execution" for your client's trades

3. **Comply with all relevant laws and regulations that govern you.**

You will need to keep informed of the laws that govern your business. Apart from securities laws, these laws could include exchange regulations and federal proceeds of crime and anti-terrorist legislation.

You may also want to establish employee policies for unsolicited communications with prospective clients to avoid violations of the communication abuse rules under federal competition law.

4. **Do not engage in conduct that would bring the reputation of the securities market into disrepute. Take all reasonable steps to determine whether a client's actions threaten the integrity of the securities market.**

You are a gatekeeper of the integrity of the securities market. It follows that it is your duty to act in the best interests of your client. However, to comply with this requirement, you must also act in the best interests of your firm and the securities industry as a whole.

If you become aware that the intention or effect of a client's trading would be in breach of securities regulations or impugn the integrity of the marketplace, then it is incumbent on you in your capacity as gatekeeper, to draw the matter to the attention of the management of your firm and potentially to regulators.

5. **If your client refuses to comply with regulatory requirements, cease to act on behalf of that client.**

You should use all reasonable efforts to ensure that your client understands the relevant regulatory requirements and their implications at all stages of a transaction. If you become aware that your client is not complying with regulatory requirements, you should inform your compliance officer and advise your client to correct the matter. If your client refuses or fails to do so, you must no longer act for that client and, as discussed above, you should consider whether to bring the client's activities to the attention of regulators.

6. **Do not contract out of any duty or liability you or your firm may have under this Code.**

For example, you cannot use client agreements in your business that purport to exclude the application of this Code or other regulations.

Principle 2 — Dealings with clients

1. **Keep your clients informed of all facts that a reasonable person would consider important to the business relationship.**

Relationships with clients are based on trust. Each client, therefore, needs to know any information, both good and bad, about you and your business that a reasonable client would want to know before entering into or continuing that relationship. You should also keep each client informed about any conditions or restrictions on your registration or trading or advising activities, as well as your relevant employment and regulatory history. For example, if you are registered as a mutual fund dealer, your representatives should inform their clients that they are only authorized to trade in mutual funds and, if offered by your firm, in securities sold under registration exemptions (known as "exempt market products").

In establishing proper communication procedures, each firm should ensure that its terms of business with a client are set out in adequate detail in a contract. Depending on the degree of variability in client arrangements, you may want to develop a flexible form of client agreement to enter into with each client.

2. **Provide clients with the information necessary to make informed investment decisions, unless your SRO permits you not to do so.**

You should make every effort to give your clients objective and impartial information about their financial needs and advise them of their various options. If a client would be better served by purchasing products or services that, for example, a mutual fund representative cannot offer, than that representative should inform the client of this fact. You should identify and explain to the client all negative aspects of proposed investments or portfolios, including the risks and costs of your recommendations. Of

particular importance are any costs that reduce the net return on the portfolio of the investor such as mutual fund management expense ratios or the spread on bonds between the price the client is paying and the price the firm paid to acquire those securities.

In addition to clearly describing the product or service for the client and the ways that the transaction will fulfill the client's needs, you should disclose important assumptions underlying any illustrations or examples provided to the client, and the fact that actual results may differ significantly from those shown. You should avoid using examples or illustrations that you know, or ought reasonably to know, are based on unusual results or on a time period that generated much better than normally anticipated performance.

To give a client additional information about a security, you should refer the client to the relevant issuer's continuous disclosure record.

To satisfy the requirements in this section, you will need to advise your client on factors other than the features of the investment itself. For example, if your client intends to invest using borrowed money, you should discuss the risks of leveraged investing. If your client is purchasing securities from you in a branch of a related financial institution, you need to ensure your client understands that your firm is separate from the financial institution, that a government deposit insurer does not insure any securities purchased, and that the financial institution does not guarantee the securities.

3. **Ensure that clients are provided on a timely basis with the records that a reasonable client would consider important respecting all transactions that you conduct on the client's behalf.**

Investment dealers and mutual fund dealers should promptly send the client all relevant information relating to a trade, having regard to the type of security being traded. This includes the particulars of the trade, any consideration the client pays in connection with the trade, and any information about conflicts of interest that apply to the trade (see Principle 6). If a client receives information about the purchase and sale of mutual funds from a fund company, you do not need to send the client the same information.

You should send your clients statements that keep them informed about the status of their accounts and about the activity in those accounts since the last statement. The objective is to ensure that the client has information on a current basis that is reasonable in the circumstances. This would normally mean monthly, but less frequent reporting may be reasonable in some circumstances (for example, if the volume and frequency of trading in the account is low, or if the client requests less frequent reporting).

Advisers should send the client all relevant information relating to advising, based on the mandate with the client. This would likely take the form of regular statements that keep clients informed about the status of their portfolio and about the activity in the portfolio since the last statement. This includes details of changes to the portfolio, any consideration the client pays in connection with those changes, and any information about conflicts (see Principle 6). The objective is to ensure the client has information on a current basis that is reasonable in the circumstances. This would normally mean at least quarterly, although you and your client may agree to more or less frequent reporting.

All firms should provide to the client anything the client will need to know to prepare and file income tax returns relating to the client's accounts with the firm.

4. **Ensure that all disclosure you provide to clients is prepared using plain language and is presented in a format that assists in readability and comprehension.**

Plain language helps investors understand your disclosure. It will ensure that they understand the securities they hold, the processes to deal with those securities, and their relationship with your firm.

Examples of "plain language" techniques include:

- Short sentences
- Definite, everyday language
- Using the active voice
- Organizing the document in clear, concise sections, paragraphs and sentences
- Avoiding legal or business jargon and boilerplate wording

Principle 3 — Confidentiality

Hold in strict confidence all confidential information acquired in the course of your relationship with clients, unless the client consents to the disclosure, the disclosure is legally required, or the client appears to be engaging in activity that could threaten the integrity of the securities market.

In the course of your relationship with a client, you will receive information about your client's financial circumstances, which is confidential. Receiving this information places you in a position of trust and responsibility and it is unethical to betray this trust. If information is disclosed, the damage to the client is the same whether or not the disclosure was intentional.

You may disclose your client's confidential information in three situations; you should explain these situations to the client at the beginning of your relationship.

First, you may disclose information if you get the client's consent, preferably in writing. Having the client sign a "blanket" consent statement allowing the general release of confidential information over an indefinite period may be acceptable. However, you should not require the client to consent to the sharing of confidential information as a prerequisite for providing service to clients or prospective clients.

Second, you must disclose if you are required to do so by law. Legal requirements include legally enforceable requests for information from the Commission, SROs, other regulators as well as provisions of applicable money laundering and anti-terrorist legislation.

Third, you must disclose your client's confidential information to the extent necessary to help regulators deal with situations where the client is engaging in activity that could threaten the integrity of the market, as contemplated in Section 4 of Principle 1.

Principle 4 — Proficiency

Maintain the proficiency, skill, and diligence necessary to properly advise and serve your clients.

The Commission or your SRO will set the minimum proficiency standards for entering the securities industry. However, in a rapidly changing financial marketplace, maintaining proficiency means that you need to keep abreast of changes in products, regulations and other factors that will affect your ability to provide high standards of client service. Education, especially continuing education, is a necessary component of business skill and the responsibility for continuing competency falls on both firms and those individuals who work for firms.

The proficiency requirement applies to all products sold by firms and representatives. Firms should consider whether the representative has been adequately trained before that representative is permitted to sell new products. For example, mutual fund dealers that allow their representatives to sell exempt market products must ensure that the persons who sell these products, their supervisors, and those who approve these products for sale by representatives of the firm, have qualifications that enable them to assess the products being sold.

Investment dealers that allow their representatives to manage client investments on a discretionary basis are expected to ensure that the proficiency of these representatives matches the increased skill demands of a discretionary relationship.

If your firm engages in underwriting activity, you should make sure that any representatives engaged in that activity have the necessary skills and training for that activity.

While the Commission will set the minimum proficiency requirements for portfolio managers of advising firms, these firms should determine their own proficiency standard for persons hired to assist in the investment management process.

The Commission will no longer mandate proficiency standards for compliance officers and branch managers. Firms will now be required to set their own standards of proficiency for these positions to ensure they are sufficient to enable these people to fulfill their essential supervisory responsibilities.

Firms should establish adequate re-qualification requirements for representatives who have been out of the securities industry long enough to affect their proficiency. Firms may want to consider the following when making proficiency decisions:

- The length of time a representative has been out of the financial industry
- The representative's relevant experience during his or her time outside the financial industry
- The representative's educational background
- Any industry continuing education courses that the representative completed while not working in the financial industry

Firms should also consider developing policies to deal with representatives employed in other occupations both inside and outside of the securities industry.

Principle 5 — Know your client and suitability

1. **Take all reasonable steps to learn and keep current your knowledge of the essential facts about the identity, reputation and financial circumstances of each client.**

2. **Determine the general investment needs and objectives of the client, the client's risk tolerance and the appropriateness of the recommendations you make to that client. Unless your SRO permits you not to do so, determine the suitability of a proposed purchase or sale for that client or the client's portfolio.**

3. **If a purchase or sale that a client requests is not suitable, advise the client that it is unsuitable before executing the proposed transaction, unless your SRO permits you not to do so.**

Principle 5 combines what have traditionally been referred to as the "know your client" and "suitability" rules. They apply to all trades made for and advice given to clients, whether or not the securities are sold under registration exemptions.

Section 1 of Principle 5, known as the "know your client" rule, requires that you understand on an ongoing basis the client's identity, background, financial position and character so you can fulfill your role as a "gatekeeper" to the market. If your client is not an individual, knowing your client means knowing the individuals that control the client, its business and its financial circumstances.

The "know your client' rule is one of the fundamental rules of the securities industry. It is incumbent on each representative to have the fullest knowledge possible of the personal circumstances, risk tolerance and investment objectives of all clients.

If someone other than your client wants to trade in that client's account, you must determine whether that person has a valid power of attorney or trading authority. In these circumstances, you will need to consider the scope of the person's authority and whether the person is a representative of a firm that is registered, or ought to be registered, as an adviser. You should also monitor these accounts to help identify whether the accounts are being used inappropriately as nominee accounts or to disguise abusive trading.

Sections 2 and 3 of Principle 5 refer to "suitability" and require that you determine what is suitable when recommending or, in most cases, selling products or services, having regard to the client's investment needs and objectives, the client's risk tolerance, and other relevant facts about the client that you know or ought reasonably to know. You should have a reasonable basis for the recommendations you make to your client. When considering the suitability of a trade or recommendation, consider the trade in the context of the client's total portfolio.

If a client requests the purchase of a security that is unsuitable, given the information on their "know your client' form, you should consider documenting to the client your opposition to such a trade.

The IDA currently has rules that exempt approved discount brokerage firms from conducting a suitability review of each trade for its clients. Therefore, the suitability requirement found under this Principle does not apply to those firms and their representatives. Those firms and their representatives must still comply with the "know your client" obligations in this Principle.

Where, with the agreement of the client, an adviser has pooled the client's funds with those of others with a view to making common discretionary management decisions for all the clients involved, the adviser must take reasonable steps to ensure that a discretionary transaction is suitable for the portfolio as a whole, based on the stated investment objectives of the portfolio.

We remind advisers that individual suitability requirements for clients are still applicable for purchases of securities sold under registration exemptions and in a "pooled fund" discretionary trading environment. You should ensure that there is consistency between the client's objectives and the investment objectives of the pooled fund.

If a firm intends to sell exempt market product, the firm should understand and approve of each product being sold before they allow their salespeople to market that exempt product to clients. Unless a firm understands the investment, it won't be able to supervise its representatives to determine if the investment is suitable for its clients.

Principle 6 — Conflict of interest

1. **Resolve all significant conflicts of interest in favour of the client using fair, objective, and transparent criteria. If there is a conflict of interest between clients, use fair, objective and transparent criteria to resolve those conflicts. In both cases, apply the criteria consistently.**

General

This Principle makes it clear that the client's interests always come first. (This should be interpreted in the context of reasonable commercial practice — an extreme interpretation would suggest that you could not charge a client a fee.) The best way to ensure that the client's interests are put first is to have appropriate procedures in place to ensure that all conflicts of interest between the firm or its representatives and the client are resolved in favour of the client and to have a system that effectively monitors and enforces compliance with those procedures. These procedures should cover conflicts of interest arising in the context of trading, advising and making recommendations. The onus of showing that the firm or representative has acted in the best interests of the client is on the firm and representative.

It could be difficult to show that you have acted in a client's best interest if the client is required or expected to deal with a particular financial institution in connection with the services you provide, or to purchase securities or pay for advice to obtain other financial products or services ("tied selling"). For example, if a related financial institution refused

to make a loan to a client unless the client purchased securities from you, that would breach this principle if the client met the normal criteria for obtaining a loan. Similarly, if you refused to deal with a client unless the client moved a mortgage to a related financial institution, that would also breach this principle.

Sometimes the conflict of interest is not between the firm or representative and client, but between clients. For example, a firm sometimes has to decide how to allocate limited investment opportunities among clients. Again, these situations are best resolved if the firm has appropriate procedures in place to deal with them, and a system to monitor and enforce compliance with those procedures. For example, this does not mean that you must offer all clients part of a particular distribution of securities. It does mean that you must have guidelines for determining to whom to offer the securities. The guidelines for making the determinations must be transparent to all clients.

Inside information

Sometimes a firm or its representatives will receive material, non-public information (inside information). If this happens, the firm must ensure that it is handled properly.

Securities legislation prohibits anyone from acting on inside information. Firms and their representatives must not buy or sell, or participate in a decision to buy or sell, a security for any account or portfolio while possessing inside information about the security or the issuer of the security. This is a complete prohibition and applies to any account or portfolio in which the firm or its representatives play any role in making investment decisions or exercise any investment discretion, or over which the firm or its representatives have direct or indirect control, regardless of whether the firm or its representatives have a personal, economic or ownership interest.

Firms may disclose material non-public information only if it is in the necessary course of business. Otherwise, it would breach the tipping provisions in securities legislation. Firms should have specific procedures for dealing with inside information.

You should create information barriers within your firm to "wall off" those who are routinely exposed to inside information from those who are not. If you restrict the knowledge to those who learn of it, and those who have a need to know it, those who do not know of it remain free to act with respect to the securities involved, whether for the portfolios under their management, for their clients' accounts or their own personal accounts. Without information barriers, the knowledge of one part of the organization could be imputed to the entire organization.

Corporate boards

If a representative serves on a board of directors or trustees, several conflicts could arise, including conflicting fiduciary duties owed to the company and owed to a portfolio or client, possible receipt of inside information, and conflicting demands on the representative's time. Your representatives should seek permission from your firm to serve on the board of directors of a public issuer or restricted issuer. Your firm should consider having policies for board participation which would identify the circumstances in which the activity would be in the best interests of the firm and its clients.

2. Develop conflict of interest procedures and disclose them to the client.

Conflicts of interest arise frequently in the securities industry and can be unique to each firm. Some conflicts can be avoided through adopting proper procedures while other conflicts are unavoidable in the context of normal business practice and should be managed as they occur. This section requires firms to develop conflict of interest procedures that work for their specific business. This section also requires you to communicate your conflict procedures to each client. You should consider doing this at the beginning of your business relationship in a way that the client can easily understand.

"Blanket" disclosure about routine compensation arrangements in general is appropriate so long as you disclose changes to those arrangements promptly. However, in other cases (for example, referral fees), disclosure should be made on a case-by-case basis so that the client can consider the information in the context of any decision the client needs to make in the circumstances giving rise to the compensation.

3. Disclose promptly to the client any information that a reasonable client would consider important in determining your ability to provide objective service or advice.

Conflicts that you cannot avoid should be managed appropriately. You must fully disclose to your clients all conflicts of interest and all potential conflicts of interest that you know, or about which you reasonably ought to know. Certain conflicts are inherent in the relationship between you and your clients, such as any remuneration you receive for selling securities to a client and any remuneration tied to recommendations you make when selling proprietary products or services of your firm or an affiliated company.

You have an obligation to ensure that your clients are aware of and understand these conflicts. Even when you believe that your actions are not affected by the conflict, you must adequately address even an appearance of conflict.

One of the most important areas for full disclosure is anything to do with compensation you receive that relates to the work you do for the client or to your relationship with the client. You must disclose fees received or paid for client referrals, sharing compensation (commission splitting), contingency fees, and any compensation incentives you receive in connection with the client or the client's business (for example, trailer fees). You must disclose this information before the client has to decide about the transaction in question.

For example, sometimes several products would be suitable for a client but one product will entitle you to a significantly higher commission or a benefit such as a trip. You should disclose this to your client when you discuss the merits of the product.

"Soft dollar" arrangements between advisers and dealers must be disclosed to the adviser's clients.

4. **When acting as an underwriter, act in the best interests of the investors and the securities market. Disclose to investors any direct or indirect relationships between you and the issuer or seller that would lead a reasonable investor to question whether you and the issuer or seller are in fact independent from each other.**

The role of the underwriter includes performing due diligence and negotiating the price and terms of the offering. In performing these functions, the underwriter is acting on behalf of public investors. Even when the underwriter is unrelated to the issuer or seller of the securities being underwritten, there are conflicts of interest involved, such as the underwriter's desire to earn the commission and underwriting fee and to be considered by the issuer for future underwriting and advising work.

To comply with this principle, it is not enough to act in the best interests of your own clients. For example, you may want to take reasonable steps to ensure that appropriate restrictions are imposed on existing securityholders so that sales of stock by this group does not disrupt the formation of an orderly market after the issuer goes public.

When the underwriter and the issuer are not independent, the potential for conflicts of interest increases. This section requires that underwriters act not only in the best interests of investors but also in the best interests of the firm, and the securities market as a whole. You are one of the "gatekeepers' of the securities industry and therefore, it is incumbent on you to uphold the integrity of the market through your actions.

Underwriters will have to be particularly vigilant in situations where there is less than complete independence. The obvious situation is cross-ownership of the underwriter and the issuer, either directly or through a parent entity. However, there can be other relationships between an underwriter and the issuer, or parties affiliated with them that would lead a reasonable investor to question whether the underwriter and issuer were in fact independent of each other.

The best way to ensure that these conflicts are resolved in favour of the investor is to have appropriate procedures to ensure that outcome and to have a system that effectively monitors and enforces compliance with those procedures.

This section requires you to disclose to the investor the circumstances of any relationship that could reasonably be perceived as less than completely independent. The disclosure should be sufficient so that the investor fully understands the nature of the conflict and its relevance to the underwriting transaction.

In some cases, the conflict may be so direct that you may conclude that following your ordinary procedures and making disclosure to investors would not be sufficient to remove the potential for real conflict, or at least the apprehension of conflict in the mind of the reasonable investor. An example would be your underwriting an issue of your own securities. In those cases, you may conclude that an independent underwriter should be involved in the transaction in a meaningful role to alleviate any concerns over the potential for real conflict.

5. **When providing security analyst services, develop, establish, and enforce conflict of interest policies that adequately address the conflicts of interest that analysts face within your firm.**

Analysts are exposed to pressures from internal and external sources as well as conflicts of interest. As a result, there is the danger that their reports and recommendations may not always be entirely objective, candid, or independent. In attempting to prevent this situation, you must develop conflict of interest policies that address conflicts for analysts specifically. Some policies you may want to consider would be to require the analyst to disclose specific conflicts of interest in each research report and recommendation issued on a company (for example, if the adviser holds a long or short position in the company's shares). The disclosure should be readable and displayed prominently, whether printed or disseminated electronically. You may also want to consider preventing any analyst that you employ from issuing research on a company when the analyst serves as an officer, director or employee of, or serves in any advisory capacity to, the company.

Principle 7 — Compliance systems

1. **Maintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, and your own internal policies and procedures. Maintain an effective system to manage the risks associated with your business.**

You must develop, implement and monitor a written compliance system that satisfies the requirements of the Code. The system you develop should be effective for your particular firm and its business procedures. Advisers should consider AIMR guidelines as a guide to good practice when constructing your compliance system.

You should consider the risks of non-compliance and establish measures designed to address them. You should list key processes, systems and structures, that you will use to ensure that your firm complies with this Code and other requirements. Your records should include evidence of all compliance monitoring. Among other things, consider if your computer and other systems are secure and can meet operational requirements.

Consider whether your system is appropriate for managing the risks of your business. If your firm uses its own capital to underwrite distributions of securities, you will need to ensure that your firm's risk management systems account for the enhanced risk that this activity poses. Similarly, if your firm is a mutual fund dealer that allows its representatives to sell exempt market products, your firm will need to ensure its risk management systems account for the enhanced risk this activity poses.

If you run your business from multiple locations, you should consider whether to designate one individual who will have compliance responsibility in some or all of those locations. Perhaps the best way to achieve effective compliance is to have the compliance function in your firm independent from other functions and have the compliance reporting relationship reflect this. In small firms with few employees, the compliance function is unlikely to work effectively unless senior operating management assumes this responsibility.

Surprise audits of a firm's satellite offices can be an effective tool in evaluating compliance with rules and procedures.

2. Ensure that your compliance function possesses the technical competence, adequate resources, independence and experience necessary for the performance of its functions.

An effective system will provide for monitoring compliance with the system. This usually requires:

- a designated individual who is responsible for the compliance function,
- staff, sufficient in number, independence, competence and authority to effectively operate and enforce the system, and
- regular audits of the system's effectiveness.

You should provide sufficient training so that new and existing staff are familiar with your compliance system. You should consider authorizing your compliance personnel to report matters directly to your board of directors, when appropriate.

3. Ensure that a representative seeking to work for your firm is suitable for work in the securities industry. Once engaged, ensure that your representative is appropriately supervised.

When hiring a representative, you should consider doing reference checks with that person's previous employer, especially if the representative was previously employed in the securities industry. You should also consider doing a criminal record and credit check on prospective employees.

You are also responsible for all trading activities and advising that your representatives do. You should not only hire people with the appropriate qualifications but should also supervise them. Those acting in supervisory positions should have sufficient experience to do so and should also be fully familiar with the firm's compliance system. For example, the person responsible for overseeing a representative selling exempt market products should make sure the representative understands the product being sold, its attached risks, and the firm's policies on selling this type of product.

4. Separate underwriting functions from the firm's trading and advising functions.

You will need to ensure there is an effective system of functional barriers (known as "Chinese walls") to prevent the flow of information that may be confidential or price sensitive between the corporate finance group and the trading and advising groups. Lapses in this area may lead to allegations of tipping or trading on inside information.

5. Separate analyst functions from the firm's underwriting functions.

If you disseminate research reports that your analysts prepare as well as carrying out underwriting functions, you need to ensure these functions are kept separate to keep the analysts from being exposed to pressures relating to your firm's underwriting activities. You should ensure that your analysts report independently to management and not through the group responsible for underwriting activities.

6. **Notify the Commission immediately of any significant change in the information relating to your organization or business.**

The information you provided when you registered is important to the Commission's assessment of your fitness as a registrant and to the Commission's ability to maintain contact with you. Therefore, any change in this information is significant and you must disclose it to the Commission. For example, if a mutual fund dealer decided to start selling exempt market products, that is a change in the firm's business and must be disclosed to the Commission. In addition, a change in the people controlling your organization is a significant change in your organization. For example, you are required under the rules to provide information in the required form for all partners, directors and officers that work for your firm.

7. **Safeguard any client monies you hold and ensure that they are used for their intended purpose. Ensure that client monies and assets are clearly identified and segregated, unless your SRO permits you not to do so.**

To safeguard monies you receive for the purchase of securities or from the sale of securities, you should purchase securities as soon as practicable after you received the purchase order and the necessary funds. Similarly, sale proceeds should be deposited into the client's account promptly.

Client funds received for the future purchase of a security, as well as securities you hold on behalf of clients, must be segregated from the firm's money and assets. Client funds and assets held in segregation should be properly identified and transparent to those clients.

Principle 8 — Client complaints

Create and use adequate procedures for handling client complaints effectively. Disclose complaint procedures to clients.

You must deal directly with all formal and informal complaints or disputes or refer them to the appropriate person or process, in a timely and forthright manner. You should be fully aware of all applicable processes for dealing with complaints and should disclose to all clients the channels available for pursuing different types of complaints (for example, regarding conduct, service or product performance).

Some registrants are also registered to do business in other sectors, such as insurance. In this case, you must inform clients of the differing complaint resolution mechanisms for each sector in which you do business and how the clients can use those mechanisms. For those persons who are also insurance licenced, you will be subject to applicable insurance regulations in this area. It is good business practice to document all complaints made against you for potential review by regulators and to respond in writing to any client who complains about you or your firm.

Securities Rules, Part 3, Division D

Code of Conduct

3D1 A registered dealer or a registered adviser must comply with, and is responsible for ensuring that its representatives comply with, all the obligations set out in the schedule [Code of Conduct].

Specified authority of representatives

3D2 (1) A registrant must maintain a current record of the trading or advising services each representative is authorized to provide on its behalf.

(2) A registrant must not authorize a representative to provide trading or advising services that are outside the scope of the registrant's registration.

(3) A representative must not provide trading or advising services that are outside the scope of the representative's authorization from the registrant.

Requirements for records

3D3 A registrant must keep records that are reasonably necessary to record itsbusiness activities and its clients' transactions, including records that

(a) permit the timely creation and audit of financial statements,
(b) allow the registrant to determine its working capital position at all times,
(c) clearly distinguish client monies and assets, including securities, from monies and assets of the registrant,
(d) identify which client is entitled to which monies and assets,
(e) identify the total number of each security that the registrant and its clients hold, and
(f) identify which transactions were conducted on behalf of which clients, including information to provide an audit trail for each instruction and order received from and for each trade transmitted and executed for a client or by the dealer as principal, in accordance with the requirements of the marketplace or the marketplace's regulation services provider or, if the trade takes place outside a marketplace, in accordance with the requirements of a reputable marketplace or market services provider.

Time for keeping records

3D4 A registrant must keep records of
(a) unexecuted orders and instructions for at least 2 years, and
(b) executed orders and instructions for at least 7 years.

Filing information about officers and directors

3D5 A registrant must provide the commission with personal information in the required form about each partner, director, and officer within 10 days of the appointment of an individual to one of those positions.

Capital adequacy

3D6 A registrant must maintain capital sufficient to meet its business obligations.

Subordination agreement

3D7 If a registrant borrows from its directors, officers, or significant securityholders in order to maintain sufficient capital to meet its business obligations, the registrant and the person from whom the registrant borrowed must enter into a subordination agreement that will ensure that claims of directors, officers, and significant securityholders are subordinated to the claims of the registrant's other creditors and clients.

Canadian registrants based outside British Columbia

3D8 Despite rules 3D2 through 3D7, a registrant and its representatives that are based outside British Columbia and comply with corresponding requirements in another Canadian jurisdiction, are deemed to have complied with rules 3D2 through 3D7.

List of representatives

3D9 A registrant must keep an evergreen list on its public website of the names of all its current representatives that trade or advise in British Columbia.

Registrants subject to requirements of authorized market delegate

3D10 Rules 3D2 through 3D7 do not apply to a registrant that is subject to the corresponding requirements of its authorized market delegate. Division E Ongoing Requirements for Advisers

Securities Rules, Part 3, Division E

Bonding requirements

3E1 (1) A registered adviser must maintain a financial institution bond for at least $200,000 covering a client's loss as a result of fidelity issues, on-premises loss of property, in-transit loss of property, forgery or alteration, loss resulting from forged, altered, lost, or stolen securities, and counterfeit currency.

(2) Despite subrule (1), if a registered adviser does not

(a) hold a client's funds, cheques, or securities,
(b) have any authority to obtain possession of client's funds or securities, or
(c) have the ability to gain control over a client's funds or securities,

the adviser's bonding coverage need only cover a client's loss as a result of fidelity issues, on-premises loss of property, and in-transit loss of property.

Annual audited financial statements

3E2 A registered adviser must file annual audited financial statements by the 90th day following the end of its last financial year.

Annual review of capital

3E3 A registered adviser must, at the time it files its financial statements under rule 3E2, file a statement disclosing the amount of capital it considers sufficient to meet its expected business obligations, and a calculation of capital showing that it has capital in at least that amount.

Inadequate capital

3E4 A registered adviser must report to the commission immediately if its capital level falls below the amount reported in the latest report filed under rule 3B5 [Capital adequacy calculation] or rule 3E3.

Canadian advisers based outside British Columbia

3E5 Despite rules 3E1 through 3E4, a registered adviser and its representatives that are based outside British Columbia and are subject to corresponding ongoing requirements in another Canadian jurisdiction, are deemed to comply with rules 3E1 through 3E4.

Appendix 2 – IDA Policy 2 Review Requirements

Daily reviews for:		
1	Lack of Suitability	Branch Office/Head Office
2	Undue concentration of securities	Branch Office/Head Office
3	Excessive trade activity	Branch Office/Head Office
4	Trading in restricted securities	Branch Office/Head Office
5	Conflict of interest between registered representative and client trading activity	Branch Office/Head Office
6	Excessive trade transfers, trade cancellations, etc. indicating possible unauthorized trading	Branch Office/Head Office
7	Inappropriate / high risk trading strategies	Branch Office/Head Office
8	Quality downgrading of client holdings	Branch Office/Head Office
9	Excessive / improper crosses of securities between clients	Branch Office/Head Office
10	Improper employee trading	Branch Office/Head Office
11	Front running	Branch Office/Head Office
12	Account number changes	Branch Office/Head Office
13	Late payment	Branch Office/Head Office
14	Outstanding margin calls	Branch Office/Head Office
15	Violation of any internal trading restrictions	Branch Office/Head Office
16	Non-client trading	Branch Office/Head Office
17	Trade cancellations	Head Office Only
18	Trading in restricted accounts	Head Office Only
19	Trading in suspense accounts	Head Office Only
20	Excessive day trading resulting in trading large numbers of contracts	Options Only
21	Trading while under margin	Options Only
22	Trading futures options without approval	Options Only
23	Trading beyond margin or credit limits	Options Only
24	Cumulative losses exceeding stated risk capital (the aggregate of cumulative profits and cumulative losses)	Options Only
25	Position and exercise limits	Options Only
26	Excessive commission activity	Options Only
27	All guaranteed accounts	Options Only
Stayed Informed of:		
1	Client complaints	
2	Cash account violations	
3	Undisclosed short sales	
4	Transfers of funds and securities between unrelated accounts or between pro and client accounts or deposits from pro to client accounts	
5	Trading under margin	

Appendix 3 – Rules Relating to Registrants

Current instruments adopted since October, 1998

Instrument	Description	Year implemented	Disposition under the BC Model
MI 31-102	National registration database	2003	Eliminated
MI 33-109	Mandates information for registration	2003	Eliminated
BCI 33-508	Exempts IDA and MFDA members from prohibition from ownership in other registrants	2003	Modified—see Code
CSAN 31-305	Registration streamlining system	2002	Eliminated
BCI 32-503	Exempts salesperson corporations from registration subject to conditions	2002	Modified—see Act s. 1A1 *representative*, Code (Principle 7)
NI 33-105	Regulates underwriting conflicts	2002	Covered by Code (Principle 6)
BCI 31-503	Exempts exchange contract dealers trading in commodity pools from registration	2001	Eliminated
BCP 31-601	Registration requirements	2001	Modified—see Dealers and Advisers Guide, other guidance, and Code
BCI 32-501	Exempts advisers of certain securities from registration	2001	Eliminated
BCI 32-502	Exempts IDA members from suitability requirements subject to conditions	2001	Modified—see Code (Principle 5)
NI 33-102	Regulates certain registrant activities	2001	Covered by Code (Principle 2, 3, and 6)
BCI 33-504	Exempts registrants from certain disclosure of client trades involving related and connected parties	2001	Covered by Code (Principle 2, 6)
BCI 33-506	Exempts registrants from the cold calling prohibition	2001	Covered by Code (Principle 1)

Instrument	Description	Year implemented	Disposition under the BC Model
BCIN 33-702	Registrants' duties when acting under power of attorney or trading authority	2001	Modified—see Code (Principle 5)
BCIN 33-703	Guidance for dealers and their salespersons	2001	Modified—see Code (Principles 1 and 7), Dealers and Advisers Guide
NI 35-101	Exempts US broker-dealers and agents from registration requirements subject to conditions	2001	Modified—see Rules s.7B1
BCI 45-502	Prescribes conditions for exemption under section 46(h) of the Act for cooperative associations	2001	Eliminated
BCI 91-504	Exemption for government strip bonds (note there is an error in the order)	2001	Modified—see Rules s.3F16
BOR 33-502	Exempts investment dealers from rewriting exams and filing a conflict of interest statement subject to conditions	2000	Modified—see Rule s. 3B11(2), 3D8, Code (Principle 4 and 7)
BOR 81-502	Exempts dealers from certain requirements in confirmation statements	2000	Modified—see Code (Principle 2)
BOR 35-501	Exempts dealers from registration requirements for remote access trades on CDNX subject to conditions	1999	Modified—see Rules s.3F3
NP 34-201	Breach of requirements of other jurisdictions	1998	Eliminated
MLP 34-202	Registrants acting as corporate directors	1998	Modified—see Code (Principle 6), Dealers and Advisers Guide

Appendix 4 – Results of Firms' Procedures Manual Reviews

Sources of Firm Policies

The following table identifies the sources of firm policies related to marketing and account supervision expressed as a percentage of total requirements

Table 1

Dealer	BCSC	IDA	Other regulator[74]	Firm policy
Firm A	6%	48%	0%	46%
Firm B	11%	52%	3%	34%
Firm C	8%	77%	0%	15%
Total	9%	55%	1%	35%

What Firms and Commission Staff Would Change Under the Code

We identified all marketing and account supervision processes in individual firm manuals and asked firms whether, under the Code, they would keep that requirement exactly as is, revise it in some way, or delete it. We then repeated the same exercise with Commission staff. The results are in Tables 2 and 3.[75]

Table 2

Percentage of account supervision and marketing rules that firms would keep or change under the Code

	Keep	Revise	Delete	No Comment
Firm A	44%	32%	24%	0%
Firm B	69%	15%	12%	3%
Firm C	64%	9%	27%	0%

Table 3

Percent of account supervision and marketing rules that the Commission would keep, or change under the Code

	Keep	Revise	Delete
Firm A	13%	29%	58%
Firm B	22%	26%	52%
Firm C	21%	25%	54%

[74] Money laundering legislation and exchange rules.

[75] The table only covers rules whose source is a regulatory requirement. The number of relevant requirements in the policy manuals of Firms 1, 2 and 3 were 79, 91, and 129, respectively.

The following are examples of areas that Commission staff believes could be simplified under the Code:

- thresholds that trigger compliance monitoring
- evidence of supervision
- daily and monthly review process for account supervision
- suitability reviews for registered representatives
- restricted accounts
- list of what must be checked in all sales communications, and by whom
- team marketing, including logo sizes
- disclaimers that appear at the end of sales literature
- order room checks
- mail handling

These items could be open to revision for a number of reasons. The level of detail could be unnecessary, streamlined processes or a new approach could replace prescribed procedures, checklists could be reduced to a smaller set of material issues, or the level of responsibility could be shifted.